TAX PROPOSALS TO FOSTER SMALL BUSINESS EXPORTS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

SECOND SESSION

WASHINGTON, D.C., MARCH 21, 1984

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE

34-046 O WASHINGTON : 1984

H721-18.

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TAX PROPOSALS TO FOSTER SMALL BUSINESS EXPORTS

WEDNESDAY, MARCH 21, 1984

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, ACCESS TO EQUITY
CAPITAL AND BUSINESS OPPORTUNITIES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. The subcommittee will come to order.

Let me welcome everyone this morning. I have a brief opening statement and we will start the testimony.

American industry has traditionally grown and prospered due to its large domestic market. Despite this fact, our industrial base is entering into a new era. In recognition of the vibrancy of the U.S. marketplace, foreign companies are increasing their shipment of goods to our shores. Our Nation's industrial base must now respond to an increasingly competitive global economy.

In statistics released this week, the U.S. Department of Commerce indicated that American exports declined last year by $11 billion to approximately $200 billion during a so-called period of economic expansion. This situation resulted in the United States importing about $60.6 billion more in goods than it exported in 1983. Many commentators state that this trade deficit could rise to $100 billion by the end of 1984. These same commentators suggest that this increased level of imports to the United States will result this year in the loss of approximately 2 million jobs.

The erosion of our industrial base and competitive position overseas cannot continue. In this context, the subcommittee is conducting an investigatory hearing today on tax proposals to foster small business exports. Witnesses will discuss the impact on small business of various proposals to replace the existing domestic international sales corporation tax incentive.

DISC was enacted in 1971, with the objective of stimulating exports through a lowering of the effective tax rate on export income. With respect to its impact on the American economy, there were 8,665 DISC's operating in 1981, with total export gross receipts of $154 billion. This is an increase of approximately $22 billion in export gross receipts from the previous year.

Nevertheless, almost since its enactment, the European Community has charged that this is an illegal subsidy for purposes of the General Agreement on Tariffs and Trade [GATT]. As a result of this controversy, the administration has urged the Congress to adopt legislation which it believes meets the concerns of the European Community and the objectives of GATT.

Whatever Congress should ultimately adopt as a replacement for DISC, it should take into account the needs of the small business person. In particular, I believe that the European Community and GATT could live with a proposal that is not unduly complex and which meets the concerns of the small business person. Although this would require a so-called de minimis rule or safe harbor for small firms, such a rule should be clearly defined by legislation and not left to regulation. Further, an explicitly defined rule for smaller firms should not appreciably upset the trade situation with our trading partners.

In summary, by providing American industry with a meaningful export tax incentive, we will be providing our work force and our cities with a hedge against future economic downturns. The future prosperity of the Nation is largely dependent upon our ability to export and develop and promote our export business.

With that brief opening, we would like now to get into the discussions of the proposals in the Senate and the proposal which this subcommittee has put forward.

I want to welcome as our first witness, the National Small Business Association. Once again, we have Herb Liebenson, who has testified on many occasions before and provided us with abundant in-depth testimony on many initiatives concerning small business; and with him is Andre Fogarasi, who is a principal in the Office of Federal Tax Services of Arthur Andersen & Co., Washington, D.C.

Mr. Fogarasi was formerly a Special Assistant to the Under Secretary for Tax and Economic Affairs of the Department of the Treasury. He received his J.D. degree from the University of Connecticut, and an LL.M. degree in taxation from New York University. We want to welcome you before the committee.

You may begin, Mr. Fogarasi.

TESTIMONY OF ANDRE P. FOGARASI, PRINCIPAL, OFFICE OF FEDERAL TAX SERVICES, ARTHUR ANDERSEN & CO.; ACCOMPANIED BY HERBERT LIEBENSON, PRESIDENT, NATIONAL SMALL BUSINESS ASSOCIATION

Mr. FOGARASI. Thank you, Mr. Chairman. Good morning. It is nice to be back. I appreciate the invitation to testify again.

We are here today on behalf of the National Small Business Association, and also on behalf of Arthur Andersen, to express our opinions and concerns with respect to small business in America.

We have submitted a prepared statement, which I would like to submit for the record. I don't want to read it. I would like to just look at the highlights.

Mr. NOWAK. Without objection, the total testimony will be admitted into the record.

I might say we are going to formulate, I think, a very broad record to present to the Ways and Means Committee in case they

don't have enough time for a hearing on this subject. We want to make sure that this aspect of the revision of DISC is put before them so that they understand the full ramifications of the effects of this, especially on small business. So your testimony will be included in total.

Mr. FOGARASI. Thank you.

The hearing is very timely today in view of the news releases from the Commerce Department with respect to the budget and the trade deficit the United States is experiencing. I think the untapped markets for exports are in the small business area, I think we have to encourage small businesses that are presently exporting to continue to export, and we have to bring new entrepreneurs to the export market.

In view of that, I think we ought to focus in on the FSC legislation that presently has been approved by the Senate Finance Committee. The Senate Finance Committee has tried to deal with the trade implications, and that is why I think they approved the FSC proposal of the administration so quickly. They modified it somewhat, and I think the modification that we are concerned with is a small business modification. As I understand it, they still have retained the interest charge DISC as their alternative for some kind of an incentive for small business to continue in the export market.

In addition, the Senate Finance Committee altered the administration's FSC proposal by increasing the limit of $2.5 million gross receipts to $5 million for definition of a small business. This change would allow a small business to participate in exporting as long as its gross receipts did not exceed the $5 million amount without actually conducting any foreign economic process or management outside the United States.

As you know, we have testified before that for small business to go outside the United States and set up operations, and have an office out there, keep its books and records outside, and conduct its business outside the United States, would be very difficult at first. But foremost, psychologically, they would not do it. They wouldn't even enter into it. Never mind the complexities and the additional cost that it would take to get overseas.

This increase in the gross receipts test by the Senate Finance Committee is obviously due to your hearings last April, and also, I am sure, of your prompting that small business has to be dealt with. We commend and thank you for the help.

I think that there is still some room for increasing that limit. I think that when we compare your proposal, H.R. 4741, we agree that maybe the $10 million figure is the right figure for the small business definition. This would allow businesses to remain in the United States and conduct their business in the United States, create jobs in the United States, and have investments in the United States, and still enjoy the export market.

In addition, the Senate Finance Committee bill still has a requirement, even with the increase in the limits, that small business has to incorporate outside the United States. I think your proposal is a much more convenient proposal for small business, in as much as they would be able to incorporate in a foreign trade zone, which means they don't have to go overseas, and this will alleviate the psychological fears of small business to a great deal.

I think in addition to these two adjustments, you have also proposed a very good amendment of the FSC legislation, with respect to including services as a covered activity. Services as it is now in the FSC legislation is not really included. It is limited in a very narrow sense to management services. Now the Senate Finance Committee, from what I understand—and there is no bill reported, so we really can't judge what the actual language—would include, however some minor management services for unrelated foreign trading companies would receive FSC benefits.

I think your provision allowing small business to enter into exporting services would give a tremendous incentive, for small business to export their services. This is an area where the United States is probably the leader in world competition. Even though we have a leading position in this area, we have recently decreased our export services in the last year.

I think that the most important thing, after the small business exemption from foreign economic process and foreign management rules, and allowance for small companies to incorporate in a foreign trade zone, is to clarify the rules for those companies which do not qualify for these exceptions. The rules with respect to foreign presence and economic process and management should be spelled out clearly in the committee report and not left to the Internal Revenue Service to draft regulations. Regulations, as you know, take usually anywhere from 1 to 5 years to come out, and then it is a retroactive interpretation of what Congress thought. Due to the fact that you are providing a tax incentive, IRS does get concerned with revenue loss and, therefore, their interpretations are usually much narrower once they write the regulations than Congress intent was to stimulate the economy.

So I think, as part of this hearing and part of your efforts, you should convince the leadership of both Houses that they should take up the clarification of some of these rules. Even though Treasury has submitted some clarification to the Senate Finance Committee as to what some of these rules mean they should be defined a lot more precisely in the committee reports.

With that, Mr. Chairman, I will close and answer any questions.

I would let Mr. Liebenson take 2 minutes of your time. He has some additional comments.

Mr. LIEBENSON. I just want say that, while H.R. 4741 does go a long way to taking care of some of the problems of DISC and would encourage additional small businesses to become exporters, there are still three other areas—I won't go into them, but I will just mention them briefly—that has discouraged the smaller companies from going abroad.

Basically, the first is the Foreign Corrupt Practices Act; the second is the present patent and trademark policies which allows representatives of the foreign governments and individuals to steal our intellectual property; and the third, of course, is the Freedom of Information Act where, again, foreign governments or foreign companies can come in and literally steal our proprietary data from records of various agencies of the Federal Government.

This is the only comment I wanted to make. Thank you.

[Mr. Fogarasi's prepared statement with attachments follows:]

PREPARED STATEMENT OF ANDRE P. FOGARASI, PRINCIPAL, OFFICE OF FEDERAL TAX SERVICES, ARTHUR ANDERSEN & CO.

Mr. Chairman and members of the Subcommittee, my name is Andre P. Fogarasi, and I am International Tax Liaison in the Office of Federal Tax Services of Arthur Andersen & Co. On this occasion, I am representing Arthur Andersen & Co. and the National Small Business Association (NSB). The NSB is a private membership organization of about 50,000 enterprises in all lines of industry and in all parts of the country. We appreciate this opportunity to present our views on H.R. 4741, the International Trade Tax Act of 1984.

My prior testimony before this subcommittee on April 14, 1983, concerning the domestic international sales corporation (DISC) and export tax incentives, commented on the Administration's proposal to replace the DISC rules with a foreign sales corporation (FSC). To Chairman Nowak's great credit, many of the problems that the FSC proposal presented for small business would be mitigated through provisions contained in H.R. 4741. Before describing some of these important improvements and commenting with respect to other matters of concern to us, I would like to discuss briefly the context within which these matters should be considered.

Timeliness of Export Incentives

These hearings are most timely in light of the serious trade situation confronting this country. The United States is facing a major crisis in its balance of trade with other countries. The merchandise trade deficit was, in 1982, $42.7

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billion and it has increased to $60.6 billion in 1983. In a recent article in Business Week, it was estimated that the deficit will hit $120 billion in 1984. In addition, with the strong position of the dollar, exporters are facing shrinking markets overseas as well as increased competition in the domestic market from cheaper imports due to the unfavorable currency exchange rates. Thus, the consideration of export incentives for American business is extremely critical at this time.

The Senate Finance Committee has recognized the importance of encouraging exports in order to overcome this imbalance in trade. Recently it has approved, with some amendments, the Administration's FSC proposal. One of the amendments (raising the exemption for small exporters) was a direct result of your subcommittee's efforts and your subcommittee should be commended. In considering this alternative and others, we believe that the potential of small business as exporters should not be overlooked. This segment of U.S. business contains 97% of all U.S. enterprises and possesses great untapped potential for export business. It should not be discouraged from export activities nor excluded from export incentives due to complex or burdensome requirements for qualification.

Our remaining comments will deal, therefore, with the provisions of H.R. 4741 as they relate to some of the problems facing the small exporter.

Problems of DISC

The entire examination of export incentives at this time is, at least in part, occasioned by the problems with DISC. A recitation of the entire history of DISC and the criticism it has received abroad from member countries of the General Agreement on Tariffs and Trade (GATT) would require much more time than is available here. Moreover, such a discussion would be somewhat moot inasmuch as it appears that there is a consensus now in the Administration that an alternative to the current tax rules must be found. In searching for that alternative, however, we believe that this Committee should keep in mind the problems faced by exporters that DISC was designed to counteract.

One principal problem was the uncertainty regarding their tax liability that resulted from vigorous scrutiny by IRS of the transfer price for export sales. The DISC provisions, by setting forth definitive rules for allocating profits between the U.S. manufacturer and its DISC, have eliminated this uncertainty. They removed the threat of double taxation and reduced profit and encouraged long-range planning in export marketing.

The DISC provisions also responded to certain other tax and economic conditions that were disincentives to exporters. Among these were the potential for current taxation of the income of a foreign sales subsidiary under Subpart F of the Internal Revenue Code and the border tax adjustments made under the value

added tax systems of various European countries. These adjustments imposed additional costs on exporters. Another factor was the unfavorable balance of trade attributable in part to the strength of the U.S. dollar.

Each of these factors continues to exist today as a reason to provide export incentives and relief from disincentives.

Improvements Over Current DISC Provisions

Despite its benefits, the current DISC provisions contain several drawbacks. One of these is the complexity of the requirements that must be met in order to maintain the status as a DISC. There are detailed rules regarding the character of income in the DISC and the type of assets the DISC might have or in which it might invest. For example, the DISC must hold certain qualified export assets, among which are obligations issued or guaranteed by the Export-Import Bank. There are also many other formal rules under the regulations that, if not met, could cause termination of DISC status and acceleration of the deferred tax liability for its shareholders.

H.R. 4741 eliminates the need for many of these rules and, in general, makes important improvements. However, it should be recognized that, to the extent the proposal eliminates the requirement to hold "qualified export assets," it could impact

the availability of export financing in the future. Thus, other low-cost loans would have to be made available.

An important aspect of this simplification is the psychological effect it could have on the willingness of small business to participate in the export business.

Small Business Exemption as an Alternative

We are concerned that many small businesses might be excluded from the proposed benefits of the FSC legislation despite its less complex provisions. In our April, 1983 testimony, we said that to satisfy the objective of preserving the ability of small business to use a tax alternative -- in the event that substantial foreign economic activities were mandatory in order to satisfy obligations under GATT -- it may be necessary to provide a special mechanism for small business. One solution would be the provision of an exemption from U.S. income tax for small exporters on their export sales. If properly defined, this exemption would be of significance to small business without significant revenue impact on the U.S. Treasury.

The FSC proposal adopted by the Senate Finance Committee would allow small exporters with $2,500,000 or less of gross receipts to avoid the foreign management and economic process tests of the proposal. As noted in Press Release 84-4, pp. 7 and

8 (attached), the Senate Finance Committee agreed to this proposal and increased the amount to $5 million of export gross receipts. Notwithstanding this exemption of small exporters from the foreign management and economic process rules, the proposal would still require small exporters to incorporate outside of U.S. custom territory and maintain their books and records in a foreign office. (H.R. 4741 would exempt small American international trading companies (small AITCs) from the need to incorporate in a foreign country and would permit them to do so in foreign trade zones. We believe this is a desirable option.)

Under H.R. 4741, up to $10 million of foreign trading gross receipts of a small American international trade company (small AITC) may be taken into account in determining exempt foreign trade income. We believe that this is the appropriate level of income for establishing a special rule to benefit small exporters. At this level, a significant number of exporters would be relieved of many burdensome requirements, yet most export gross receipts would still be subjected to the rules regarding foreign economic processes. For example, in the 1980 DISC year, DISCs with gross receipts under $10 million (nearly 85% of all DISC returns), accounted for less than 10% of total DISC gross receipts, according to the Treasury's 1980 Annual Report on DISCs.

It would seem that an exemption could be provided, without all of the formal FSC requirements, to accommodate these small exporters without injuring or offending other GATT members.

Clarification of Requirements

In earlier testimony, we stated that we were concerned that that the Administration's FSC proposal would not be available to be used by small business due to the many complicated requirements. Some of these requirements are easily understood, but others are less clearly defined. For example, it is by no means clear whether, in fact, it is intended that substantial economic activity must occur outside the U.S. and if so, to what degree. Another issue is, does the requirement to maintain the books and records in the foreign office necessitate that an employee located overseas post entries to a general ledger or is it sufficient that a copy of the year-end financial statements be kept in that foreign location?

For small businesses, this lack of clarity has been eliminated in some respects in H.R. 4741 due to the removal of the foreign economic process requirements and the requirement that a small AITC maintain an office outside the U.S. and that a set of permanent books of the corporation be maintained there. This is an important and welcome provision and will, we believe, greatly enhance the use of the AITC by small business.

With respect to other companies, however, the importance of clarifying the requirements cannot be overemphasized. It should be done by Congress with particularity so that the Internal Revenue Service will not interpret and administer these requirements in H.R. 4741 so strictly that the intent of the statute would be defeated.

Service Income as Foreign Trading Gross Receipts

The Senate Finance Committee has recognized the importance of encouraging the export of services as well as goods and has amended the Administration's proposal so that the income from the performance of certain services qualifies for tax exemption. The provisions of H.R. 4741 go much further, and would treat income from a much broader list of services performed by small AITCs as foreign trading gross receipts. We believe this is the proper direction to take. The service industry is an important segment of our economy and is becoming more so all the time. Although there was a balance of services trade surplus in 1983 of $28.4 billion, this was 15% less than the surplus the previous year. It is not likely that our trading deficit will be corrected solely by encouraging the export of goods. The export of services should also be encouraged.

Conclusion

We would like to urge this Committee to enlist the aid of leaders of both the House of Representatives and the Senate so

that the FSC proposal agreed on by the Senate Finance Committee can be modified according to the proposals contained in H.R. 4741. We believe that if the proposals of H.R. 4741 are incorporated in the FSC legislation it will encourage a great number of small exporters presently in the marketplace to continue their operations and will also encourage small entrepreneurs to enter the export business. We would be pleased to work with the Committee in any way to help foster small business participation in the export sector.

34-046 O—84—3

Press Release No. 84-4

PRESS RELEASE

FOR IMMEDIATE RELEASE
March 12, 1984

UNITED STATES SENATE
COMMITTEE ON FINANCE
SD-219 Dirksen Senate
Office Building

FINANCE COMMITTEE ACTION ON VARIOUS BUDGET MEASURES

The Honorable Robert J. Dole (R., Kans.), Chairman of the Committee on Finance announced that the Committee in Executive Session tentatively agreed to the following provisions to reduce spending and increase revenues:

March 1, 1984

Spending Provisions

Grace Commission Recommendations

The Committee agreed to reduce outlays by implementing three recommendations of the President's Private Sector Survey on Cost Control.

1. The Committee agreed to authorize the Internal Revenue Service to offset delinquent nontax debts owed the Federal Government against Federal income tax refunds. Federal agencies referring delinquent debts to the IRS would be required to adopt procedures to ensure that debtors received adequate notice of the delinquency and an opportunity to respond before referral in order to ensure that the offset procedure was utilized only as a last resort. The refund offset authorization would be effective on January 1, 1986, and would expire on December 31, 1987, to allow for a review of the program.

2. The Committee agreed to authorize and require the Internal Revenue Service to make available data on unearned income to Federal and State agencies administering means-tested Federal benefit programs. This data could be used by recipient agencies exclusively for the purpose of verifying eligibility for benefit programs with income and asset eligibility standards. Agencies receiving IRS data would be subject to the restrictions on unauthorized disclosure of confidential information that are currently applicable to the IRS. The Committee also agreed to

permit the Labor Department to require States to collect quarterly wage data for purposes of income verification.

3. The Committee agreed to direct the Treasury Department to issue regulations requiring agencies to implement the Grace Commission recommendations for accelerating the collection and deposit of nontax Federal receipts.

Revenue Provisions

1. Modifications to Section 1231

The Committee agreed to a modification to the tax rules governing gains and losses on property used in a trade or business (section 1231 property). Under the modification, gains and losses on such property would continue to be netted against each other, with net gains treated as long-term capital gains, and net losses treated as ordinary losses. However, the period for netting gains and losses would be extended to three prior taxable years and three succeeding years, to prevent manipulation of the netting rules by taxpayers timing the realization of gains and losses to occur in alternate years.

The proposal would be effective for taxable years beginning after December 31, 1984.

2. Treatment of Interest Attributable to Deferred Payments

The Committee clarified that the test rate for Section 483 imputed interest would equal 110 percent of the yield-to-maturity of Treasury instruments having a similar maturity. The imputed rate would equal 120 percent of the yield-to-maturity of such Treasury instruments.

3. Tax Swaps

The Committee also agreed, subject to Treasury and staff being able to develop adequate rules which do not limit IRS authority under present law, to prohibit two or more taxpayers from converting personal use property to business or investment property by buying and leasing substantially similar property to each other.

4. Prepayment of Expenses

The Committee clarified that (1) deductions for prepayments of expenses would not exceed a taxpayer's investment, (2) such deductions must have a business purpose, and (3) no deduction would be allowed for interest on indebtedness incurred to make such prepayments. The Committee also agreed that this rule should not be construed as less stringent than present law.

The proposal would apply to prepayments made after the date of enactment.

5. Individual Minimum Tax

The Committee agreed to revise the individual minimum tax so that deductions (other than tax preferences) from limited business interests and rental activities in which the taxayer does not materially participate, in excess of income from all such activities, would be treated as a tax preference. A taxpayer could elect to defer part or all of those deductions until the next taxable year. The proposal would apply only to losses in excess of the taxpayer's actual cash investment (including recourse debt).

Income excluded under section 911 would be a tax preference. As under present law, the foreign tax credit would be allowed against the minimum tax attributable to that income.

The proposal would be effective for taxable year beginning after December 31, 1984.

6. Luxury Automobiles and Similar Items

The Committee agreed that for personal property which typically is used both for business and personal purposes, to require a threshold of 50 percent business use before ACRS (or deductions for rental payments) would be allowed. The deduction for use in excess of 50 percent would still be prorated. If business use drops below 50 percent, recapture of previously allowed ACRS deductions would be required, measured by reference to the then fair market value of the property. If business use is less than 50 percent, a deduction for depreciation would be allowed under an extended recovery period. In addition, increased substantiation requirements could apply. For all other property, recapture would be required upon any conversion to personal use.

The proposal would be effective for property placed in service after March 1, 1984, in taxable years ending after such date.

March 7, 1984

Revenue Provisions

1. Source of Transportation Income

Under present law, transportation income can be treated as almost all foreign even if the transportation is between two U.S. points, if the route of transport lies primarily outside the United States' three mile territorial limit.

The Committee agreed that income earned from transportation that begins and ends in the United States (or U.S. possessions) would be treated as U.S. source income. Income earned from transportation would include services income and leasing income from ships, airplanes, and containers used in connection with ships and airplanes. The provision would be effective on the date of enactment.

2. Factoring Trade Receivables

Under present law, taxpayers have taken the position that they can sell trade receivables to a related foreign corporation at a discount ("factor" them), without U.S. tax either at the time of sale or when the foreign corporation receives payment on the receivable. If the factor is located in a tax haven, it may earn interest income free of current U.S. or foreign tax. That income may be foreign-source income that is sheltered by excess foreign tax credits. Some taxpayers take the position that the purchase of the receivables from a U.S. person by the foreign subsidiary avoids the rule of present law that treats certain investments in U.S. property by a controlled foreign corporation as taxable to its U.S. parent.

The Committee agreed that when a foreign subsidiary of a U.S. owner receives payment on a receivable that (1) it bought from a related person, and (2) the related person had taken in exchange for inventory, the U.S. owner would be taxed on that factoring income. The proposal would treat income from a related U.S. person's receivables as U.S. source income. The proposal would also treat payments of cash from a foreign subsidiary to a related U.S. person for receivables arising from the U.S. person's sales of inventory as investments in U.S. property. Thus, payments of cash for receivables will be taxable as dividends to the U.S. parent. The proposal would apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after that date.

3. Recharacterization of Income for Foreign Tax Credit Purposes

The Committee agreed to a proposal that would restrict

opportunities available under present law to route U.S.-source income through a foreign subsidiary and convert it into foreign source income, thereby artificially increasing foreign tax credits. It would also prevent conversion of interest income into dividend income in order to avoid the separate foreign tax credit limitation on interest income. This proposal would apply to income earned by foreign subsidiaries and other conduit entities after the date of enactment, but it would not apply to interest on term debt outstanding on March 1, 1984.

4. Trust Provisions

a. Multiple trusts

Treasury regulations prevent grantors of trusts from reducing present taxation by establishing multiple trusts for the same beneficiaries which take advantage of the separate graduated rates applicable to each trust. A recent court decision held these regulations to be invalid. The Committee agreed that trusts established by substantially the same grantors for substantially the same beneficiaries with a principal purpose of tax avoidance would be consolidated for tax purposes under Treasury regulations. The provision would be generally effective for taxable years beginning after March 1, 1984.

b. Trust distributions

Under present law, beneficiaries are taxed on the fair market value of property distributed from a trust (or estate) to the extent of the trust's (or estate's) distributable net income. The trust (or estate) is allowed a deduction for amounts taxed to its beneficiaries. The basis of the property in the hands of the beneficiary is stepped up to its fair market value even though no tax is imposed on the unrealized appreciation.

The Committee agreed that distributions of property would be deductible by the trust only to the extent of the property's basis. The beneficiary's basis would be the same as the trust's (or estate's) and the appreciation would no longer be exempted from tax. Alternatively, the trust may elect to recognize gain on the distributed property. In such event, the beneficiary would receive a fair market value basis as under present law.

The provision would apply to distributions after March 1, 1984.

5. Finance Leasing

Under present law, liberalized rules for limited use property and fixed price purchase options became effective on

January 1, 1984. The Committee agreed to postpone that effective date for four years. Present liberalized leasing rules would be continued for up to $150,000 of farm equipment. In addition, certain transition rules would be provided.

6. Ordinary Nonliquidating Dividends of Appreciated Property

Generally, under present law, a distribution of appreciated property (including, for example, interests in an oil and gas royalty trust) by a corporation with respect to its stock is not a taxable event to the distributing corporation.

The Committee agreed that, in general, an ordinary nonliquidating distribution of appreciated property would be taxable to the distributing corporation. The provision would not apply to dividends of business property (other than inventory) to individual shareholders who have held more than ten percent of the stock for at least five years. The provision would apply with respect to distributions declared after the date of enactment with a transition rule.

7. Pre-opening Expenditures

Under present law, taxpayers may elect to amortize pre-opening or start-up expenditures over the first five years after the business is opened. If the election to amortize is not made, the IRS views these expenditures as non-deductible capital items. Certain taxpayers, nevertheless, claim those items as currently deductible if the five year amortization election is not made.

The Committee agreed to make five-year amortization mandatory.

8. Income Forecast and Units of Production Depreciation

Under present law, property depreciated under non-ACRS methods, such as typically is the case with movies and sound recordings, and property using units of production methods, may obtain more beneficial cost recovery and investment credit treatment than ACRS property.

The Committee agreed to a proposal which would ensure that non-ACRS property receives no more favorable treatment than ACRS property could by providing that where a taxpayer claims a six-percent credit, it may not claim depreciation faster than that allowed for three-year property; where a ten percent credit is claimed, depreciation could not be claimed faster than that allowed for the five-year property. The proposal would not apply to movies since restrictions placed on the investment tax credit for them by the Tax Reform Act

of 1976 provide for a credit that is two-thirds the normal credit. These changes would be effective January 1, 1985.

9. Foreign Sales Corporations

Present law provides a system of tax deferral for Domestic International Sales Corporations (DISCs) and their shareholders. A DISC is a domestic subsidiary of a U.S. company engaged in exporting. The income attributable to exports may be apportioned between the parent and the DISC using special pricing rules.

The Committee agreed to the Administration's Foreign Sales Corporation proposal as a replacement for DISC, with certain modifications. The provision would allow the establishment of foreign sales corporations (FSCs) which typically would be foreign incorporated subsidiaries of U.S. parent corporations engaged in exporting. To qualify as a FSC, a corporation would have to be organized under the laws of a jurisdiction outside the U.S. customs area and meet certain foreign presence requirements.

The tax rules of the proposal would apply to the export income of a FSC if it were managed outside the United States and if some economic processes of the transaction took place outside the United States. In addition, the proposal would apply to the export income of a small FSC attributable to up to $2,500,000 of export receipts whether or not its management or economic processes were foreign.

Under administrative pricing rules, the FSC generally would earn the greater of 23 percent of the taxable income that it and its related party derive from an export transaction or 1.83 percent of the gross receipts from the transaction.

The proposal would exempt a portion of the export income of a FSC from U.S. tax. If a transaction were subject to one of the administrative transfer pricing rules, this exempt portion would be 17/23 of the FSC's income from the transaction. The rest of export income (including generally 6/23 of the FSC's income) would be subject to U.S. tax. Dividends from export income paid by a FSC to a U.S. corporate shareholder would be tax-exempt at the corporate shareholder level.

The proposal would provide tax deferral under the present DISC rules for up to $10 million of export receipts but would require those companies to pay interest on the deferred tax. In addition, the proposal would treat accumulated DISC income as having been previously taxed, so that tax on those amounts would be forgiven.

The Committee also agreed to the following modifications

of the Administration's proposal:

(a) A FSC may be organized only in a foreign country that is either (i) a party to an exchange of information agreement that meets the standards of the Caribbean Basin legislation (now section 275(h) of the Internal Revenue Code) or (ii) an income tax treaty partner of the United States, and the Secretary of the Treasury certifies that the exchange of information program with that country under the treaty is satisfactory.

(b) An increase in the small business exception from $2.5 million to $5 million of export gross receipts.

(c) A FSC that performs managerial services (such as export market studies and contacting potential foreign purchasers) for other FSCs will be eligible for FSC treatment for the resulting income, whether or not it is engaged in exporting.

(d) The untaxed export trade income of an export trade corporation (ETC) may be treated as previously taxed income and, therefore, exempt from U.S. tax.

(e) Instead of the Administration's provision dealing with agricultural cooperatives, the taxable income of a cooperative for the purpose of applying the administrative pricing rules would be determined without regard to deductions for distributions to patrons. Thus, the agricultural cooperative's share of exempt foreign trade income would be taxed to the patrons of the cooperative when distributed by the cooperative. In addition, an agricultural cooperative's pro rata share of nonexempt foreign trade income of a FSC would be taxed to the patrons of the cooperative (as normal patronage source income) instead of at the FSC level. The taxable income of the cooperative eligible for FSC benefits must be based on an arm's-length transaction.

(f) Certain technical amendments.

(g) The effective date of the proposal would be changed to December 31, 1984.

March 8, 1984

Revenue Provisions

1. Nuclear Decommissioning Costs

The Committee agreed to an amendment which would permit utility companies owning nuclear power plants to take

deductions for the discounted estimated future costs of decommissioning the plants. Annual deductions would be permitted for discounted amounts determined under a formula developed by the Treasury Department, provided a segregated decommissioning fund is maintained by the utility. The earnings of this fund will be subject to Federal income tax unless tax-exempt under some other provision of the Code.

The Committee also agreed to clarify present law by providing that all customer charges for decommissioning must be included in the income of the company that is providing the electric services, notwithstanding any dedication, deposit, or transfer of the funds to provide for future decommissioning costs.

2. Changes in Effective Dates of Provisions Previously Reported and Contained in S. 2062

The committee agreed to the following changes in the effective dates of the tax provisions of S. 2062, the Omnibus Reconciliation Act of 1983, reported by the Senate Commitee on the Budget on November 4, 1983.

Provision	S. 2062 As Reported Effective	New Effective Date
1. Estimated payments of minimum tax	1/1/84	1/1/85
2. Increased income averaging threshold	1/1/84	No change
3. Postponement of net interest exclusion	1/1/85 (ending 1/1/87)	No change (ending 1/1/88)
4. Exclusion for cancellation of student loan indebtedness	1/1/83	No change
5. Phaseout of graduated corporate rates	1/1/84	No change
6. Tax-exempt leasing	5/23/83	No change
7. Capital gains holding period	11/1/83	3/1/84
8. Capital loss offset against ordinary income	1/1/84	1/1/85
9. Sport fishing tax	10/1/84	No change
10. Stock option straddles	11/1/83	No change

11. Foreign investment companies	11/1/83 and 5/23/83	No change
12. Collapsible corporations	1/1/84	1/1/85
13. Compliance provisions	1/1/84	1/1/85
14. FIRPTA withholding	Enactment	No change

3. Foreign Sales Corporation (FSC)

The Committee approved an amendment to the FSC legislation tentatively approved on Wednesday, March 7, 1984, with respect to agricultural cooperatives. The amendment would permit cooperatives to own a FSC and export through it, with the benefits of the FSC being passed to the patrons of the cooperative. A requirement that the patron deal with the cooperative at arm's length was also approved.

The Committee further agreed to a January 1, 1985, effective date for the FSC proposal.

4. Nonstatutory Fringe Benefits

The moratorium on the issuance of fringe benefits regulations would be extended for two additional years (i.e., through December 31, 1985). The freeze would apply to faculty housing where the faculty member pays the cost of the housing.

5. Net Operating Losses

Effective January 1, 1984, the suspension of the effective date for the limitations on net operating losses added by the Tax Reform Act of 1976 would be extended to transactions on or before December 31, 1985. However, for transactions involving title 11, the Tax Reform Act of 1976 provisions would be effective for transactions beginning January 1, 1984, and on or before the date of Committee action. For transactions beginning after the date of Committee action, the provisions applicable before the 1976 Act would apply.

6. Employee Educational Assistance

The income tax exclusion for benefits under employer-provided educational assistance programs would be extended for two additional years (i.e., through December 31, 1985), and the rule of the Greensboro Pathology Associates case concerning employer deductions for pre-funding educational benefit trusts would be reversed.

7. Demolition of Historic Structures

The disallowance of income tax deductions for costs of demolition of certified historic structures would be reinstated and made permanent. A current deduction for the costs of demolition of other structures would be denied. Instead, the costs would be included in the basis of the land or, where appropriate, the basis of a new structure on that land.

8. Architectural and Transportation Barrier Removal Expenses

The deduction (sec. 190) of up to $35,000 per year for expenses incurred in eliminating architectural and transportation barriers to the handicapped would be reinstated for two years to apply to expenses incurred in taxable years beginning in 1984 and 1985.

9. Reporting of State Tax Refunds

The requirement imposed by the Tax Equity and Fiscal Responsibility Act relating to reporting of State tax refunds after 1982 would be modified to provide that the information return (1099) to be given to the taxpayer may be provided with the refund check. A State would be made subject to a penalty for failure to provide an information return after the date of enactment; however, a State would not be required to have sent a 1099 with respect to refunds made prior to the date of enactment.

A similar provision was approved by the Senate during its consideration of H.J. Res. 290 on November 18, 1983.

10. Estate Tax Installment Payments

The provision would amend the estate tax installment payment provision (sec. 6166) to permit consideration of the value of certain active business stock owned indirectly through ownership of an interest in a passive holding company in determining whether an estate qualifies for installment payments. The special four-percent interest rate and five-year deferral of principal payments will not apply to estates electing this provision.

11. Rehabilitation Tax Credit

The rehabilitation tax credit for older buildings would be extended to cases where the following criteria are met: (a) at least 50 percent of the building's external walls are retained as external walls; (b) at least 75 percent of the building's external walls are retained as either internal or external walls; and (c) at least 75 percent of the building's

internal structural framework is retained.

12. Exemption from Aviation Excise Tax for Certain Helicopter Operations

The present exemption from the airways fuels and passenger ticket taxes for helicopters engaged in timber operations and hard mineral exploration, and not using the ADAP system, would be extended to such helicopters engaged in oil and gas exploration, effective on April 1, 1984.

13. Multiemployer Pension Plan Withdrawal Liability

The general effective date provided in the Multiemployer Pension Plan Amendments Act for employer liability to a multiemployer pension plan upon withdrawal from a plan would be changed to September 26, 1980 (date of enactment of the MPPAA).

14. Rollover to IRAs

Relief would be granted for certain pension plan distributions received during 1976 and 1977 and transferred to an individual retirement account. Under the proposal, the transfers would be treated as a tax-free rollover.

15. Technical Correction of FICA and FUTA Exemption for Certain State Retirement Plan Contributions (PERS Pickup)

A technical correction to the Social Security Amendments of 1983 would be provided to ensure that employer payments of employee contributions under a State or local retirement plan that is a pick-up plan (under sec. 414(h)) are subject to FICA and FUTA only if the payments are made pursuant to a salary reduction arrangement.

16. Tax Treatment of Regulated Investment Companies

Under present law, a personal holding company cannot qualify as a regulated investment company (RIC). For short-term government obligations, original issue discount is taxed on disposition or maturity.

Under the proposal, a personal holding company could qualify as a RIC, and a RIC could elect to accrue original issue discount on short-term obligations. It would be clarified that tax-exempt interest remains tax-exempt when distributed to RIC shareholders.

17. Cooperative Housing Corporations

All persons would be allowed to qualify as tenant-stockholders of cooperative housing corporations, and certain

individuals and other persons would be treated as entitled to occupy their cooperative units even if the cooperative housing corporation retains the right to disapprove occupancy. Tenant-stockholders of a cooperative housing corporation who use units in a trade or business would not be allowed to deduct rental payments to the extent such payments are attributable to amounts paid or incurred by the corporation that are required to be capitalized.

18. Income Tax Exemption for U.S. Military and Civilian Government Personnel Killed From Overseas Injuries

If a member of the U.S. Armed Forces or a civilian employee of the United States dies while in active service from wounds, or injury incurred (after 1979) as a result of a terroristic or military action outside the United States, no U.S. income tax would be imposed on the individual's income beginning with the year preceding the year in which the wounds or injury were received.

19. Abatement of Penalties--Contest Award (Roseann York)

In the case of an individual who won a home designed for her handicapped foster son in a radio contest, penalties would be abated and collection activities would be deferred for six months after the date of enactment, to permit the taxpayer to arrange for payment of the underlying tax liability.

20. Special Estate Tax Credits--Estates of Nell Redfield and Elizabeth Rabe

A special credit against Federal estate tax would be allowed on the estates of Nell J. Redfield and Elizabeth Schultz Rabe. The credit would apply to the transfer to the Secretary of Agriculture, for addition to the Toiyabe National Forest, of real property located in or near the boundaries of that forest (the real property is part of the estates in question). The amount of the credit would be the lesser of fair market value of the transferred property, as determined for estate tax purposes, or each estate's Federal estate tax liability (plus interest).

21. FUTA Treatment of Fishermen

Fishing boat crew members who are treated as self-employed for purposes of income tax withholding and social security tax would be treated as self-employed and therefore not subject to tax under the Federal Unemployment Tax Act. Crew members generally are treated as self-employed if their remuneration is a share of the catch and if the crew of each boat normally is made up of fewer than ten individuals. The provision would be effective for taxable years beginning after 1982 and before 1985.

22. Coordination of Foreign Personal Holding Company Rules and Subpart F

Same country dividends would be excluded from the foreign personal holding company provisions. The coordination between subpart F and the foreign personal holding company rules would be clarified by giving subpart F priority. It would be made clear that the foreign personal holding company rules could not be avoided by insertion of an entity between a U.S. shareholder and a foreign personal holding company.

23. State Pension Plans--Required Distributions (sec. 401(a)(9))

The effective date of the TEFRA changes relating to distributions from a qualified pension plan would be delayed to January 1, 1987, for a plan maintained by a State.

24. Unemployment compensation for Pre-1978 Periods

The Revenue Act of 1978 would be amended to provide that the provisions of that statute which make includible in income a portion of unemployment compensation benefits apply to payments of unemployment compensation made after 1978 except payments for weeks of unemployment ending before December 1, 1978. The period for claiming any credit or refund attributable to this amendment would also be extended until one year after enactment.

25. PIK

The tax provisions relating to the Payment in Kind program would be extended to 1984 for spring wheat.

26. Wildlife Refuge System

Issuing of the symbol appearing on duck stamps would be permitted for a fee that would be paid into the Migratory Wildlife Fund.

27. Estate and Gift Tax Marital Deduction--Technical Amendment

It would be made clear that a usufruct interest is treated as a qualified income interest for life that may qualify for the marital deduction.

28. Pension Portability

Individuals who were employees of AT&T before the split-up and who became employees of the companies created by the split-up would be entitled to credit for pension purposes

for past service for AT&T.

29. Social Security for Congressional Employees

The amendment, which was previously approved by the Committee, would require that an individual in Congressional employment maintain continuous participation in the Civil Service Retirement System (CSRS) in order to retain an exemption from social security.

30. Treat Taxable Alimony as Compensation for IRA Purposes

Taxable alimony received during a year would be treated as compensation for purposes of applying the IRA deduction limits without the conditions and limitations of present law.

31. Tax-Exempt Status for Nonprofit Dependent Care Facilities

A dependent care facility would be treated as a section 501(c)(3) organization, and thus receive tax-exempt status and be eligible to receive tax-deductible contributions if (1) the organization is operated to provide nonresidential care; (2) substantially all of the dependent care is provided to enable individuals to be gainfully employed; and (3) the services provided by the organization are available to the general public.

32. Make Permanent the Tribal Indian Tax Status Act

The Tribal Indian Tax Status Act treats Tribal governments as State governments for purposes of the Internal Revenue Code (but without authority to issue IDBs). The provision expires after 1984. The proposal would make the Act permanent.

33. Exemption of Certain Sewage and Solid Waste Disposal Facilities that Provide Energy from the Limitation on Small Bond Issues

Capital expenditures for solid waste disposal facilities that produce energy would be excluded for purposes of computing the $10 million limit on small issue IDBs.

34. Technical Amendments to Tip Reporting

The TEFRA tip reporting requirements would be modified: (1) to allow a majority of the employees of a restaurant to demonstrate that their average tip is below eight percent; (2) to allow tips to be proved down to two percent rather than present law five percent; and (3) by requiring the IRS to issue guidelines on reporting and recordkeeping requirements for tipped employees.

P.R. #84-4

Mr. NOWAK. Thank you very much.

Let me ask this question of both or either of you. We talk about an alternative in the administration's bill, that you would have to pay some interest in lieu of using a foreign sales corporation if you earned over $5 million in profits, as it stands now, anyway.

Do you have any feeling as to how many small businesses would take that alternative?

Mr. FOGARASI. I think I could give you general comments. I think the interest charge DISC, as they are referred to in the Senate Finance Committee bill, is really the administration's proposal. The last time I testified, we did a very quick survey as to how many people would actually use that. First of all, nobody could really figure out how you do the calculations. Second of all, it would make a financial wizard blush to do the constant calculation of the Treasury bills and rollovers in order to get the deferral. Most of the people we talked to said they would not use it. Therefore, I don't think it is a very effective way to help small business.

Mr. NOWAK. It wouldn't be an effective alternative?

Mr. FOGARASI. No. I think that this alternative, if you ask, most of the small business people will tell you that it is not very effective and they wouldn't elect it.

Mr. NOWAK. Let me call on Mr. Jim Olin from Virginia, who has been a supporter of trying to make this adjustment in the DISC and give small business the proper incentive. He has spent much time with this subcommittee and the counsels going over this program. I want to express my appreciation.

Mr. OLIN. Thank you very much, Mr. Chairman.

I apologize for not being here at the beginning of your testimony, but I picked up at least the last part.

I take it that both witnesses are basically in favor of this bill.

Mr. FOGARASI. Yes.

Mr. LIEBENSON. Yes.

Mr. OLIN. You are suggesting the possibility of some improvements in it.

I wanted to get some feeling on your part as to the degree to which you felt that adding this export help would stimulate more export activity by small business. Could you, perhaps, even at the risk of repeating yourself, give some idea of how significant you think this would be in terms of helping in the present situation?

Mr. FOGARASI. Since I am not an economist, I am not going to discuss the feedback analysis of exporting and who would enter into the export market because of what incentive.

But I would presume in a very simplistic way that if you give me a benefit, a tax incentive, to enter into a certain market, I am certainly going to take advantage of it if it makes sense for me businesswise. If you have excess production, I think the export market would be the place I would go if you give me an incentive in that market.

I think, presently, small businesses have been frightened away with the complexities of DISC. DISC had a lot more rules and requirements, and I would say that most people were probably in violation of one or other regulation requirements in the present law. It also costs a lot more in professional fees, so I think the simplifi-

cation would help. I think the FSC proposal would be a simplification.

I think that it should be made clear that we do support the FSC. We don't want to hinder it in any way. We would like to just maybe change a few words to help small business.

As far as numbers, to give you numbers, there is no way I could give you that.

Mr. OLIN. You don't really have them.

I was thinking in terms of the real impediment right now, probably the largest impediment, is the value of the dollar.

Mr. FOGARASI. Yes.

Mr. OLIN. It is a huge factor. It could be 25, 30, 35 percent in some cases, maybe more.

The leverage of this tax incentive is small, I take it, as compared to a 30-percent problem with the dollar?

Mr. FOGARASI. Let me just remind you, Congressman, that originally DISC was enacted because there was a trade deficit, and also because the dollar was strong. We are back at the same position today. I think exporters face the problem that the dollar is so strong that the export market is shrinking.

Not only that, but you now have the counterposition where the foreign markets are exporting into the United States at a cheaper price because of the unfavorable currency exchange rate, vis-a-vis the dollar. So I think they are squeezed from both sides. So I think you either help the exports—and if you look at some of the studies that have been made, they say that the currency exchange rate changes in an 18-month cycle based on exports as well. We don't have 18 months to see the trade deficits to go up to roughly $120 billion, which is what they are predicting.

Mr. OLIN. OK. I take it that you are totally favorable toward this bill, you think it would help, and regardless of whether it might not solve the whole problem, is it definitely a step in the right direction?

Mr. FOGARASI. I agree. Nothing solves the whole problem that I have ever been involved in.

Mr. OLIN. Thank you, Mr. Chairman.

Mr. NOWAK. I think that your reflection as to the strength of the dollar really does show in Mr. Fogarasi's answer concerning why DISC was put in the law in the beginning to try to make some internal adjustments to help our total industry export and find the markets. When we look at the other kinds of incentives that are in place by foreign nations, we need to make sure that goods and services over and above the dollar exchange problem that we have adjustments which favor our exports, I think, are going to have to be made very strong if we are going to be competitive at all.

When you take the strength of the dollar and other factors—tax laws and everything else—that affect the total cost of that good to be exported. We will see this trade deficit keep moving up in tremendous numbers over the next few years, unless we can make some adjustments here that our trading partners have already made and exercised for many, many years and have perfected subsidies on exports. There is no really viable way that we can provide this kind of incentive unless we improve this DISC situation.

Unless you are willing to look at other kinds of overt funding, of direct involvement in trade shows and marketing and sending our small businessmen overseas, we will not be able to come up with the kinds of dollars that it takes to expose products and market products overseas. This is, I think, one very necessary little step to try to make this whole adjustment to the transition we have seen.

We want to thank you for your testimony. Certainly your written testimony is very complete. We appreciate the time and effort that I know that this testimony took to put together. We want to keep the record open, however, because as we go through all the other testimony, we are going to try to fill in any gaps we may have, so we may be calling you back to ask further questions in writing to complete the record.

Mr. FOGARASI. Thank you, Mr. Chairman.

Mr. LIEBENSON. Thank you.

Mr. NOWAK. Thank you very much.

Our next witness is from the National Federation of Independent Business, John J. Motley III, who is director of Federal legislation.

John, if you will come forward. John, of course, has testified before this subcommittee on several other occasions, and continuously has been an active participant in the small business tax and capital formation debate for many years. We want to welcome you once again before the subcommittee.

TESTIMONY OF JOHN J. MOTLEY III, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MOTLEY. Thank you, Mr. Chairman.

I see that my timing was excellent. It took a little while to get into the building this morning. There must be an awful lot going on.

It is a pleasure to be here again. I want to thank you for the opportunity to come and testify on this subject. I also want to thank you for introducing the fine piece of legislation that you have put in on this area.

NFIB, like most of the other small business groups throughout the country, is very concerned about the lack of activity within the small business community in the exporting area. We have been looking rather unsuccessfully for a number of years to find ways to encourage more small firms to get involved. Therefore, we do appreciate your efforts to take a look at this, and also what appears to be a governmentwide effort right now to try to come up with some new incentives for the small business community to get more deeply involved in exporting.

I have a prepared statement which I would like to submit for the record. I would like to pick up our specific comments on S. 1804 and your bill.

Mr. NOWAK. The total statement, without objection, will be admitted into the record.

Mr. MOTLEY. Thank you, Mr. Chairman.

S. 1804 presents three options for small exporters. The first option is eligible to exporters with $10 million or less in export receipts, that is, to continue the use of DISC rules with one modifica-

tion. DISC earnings need not be distributed to shareholders, thereby granting a permanent deferral on total DISC earnings. If this option is chosen, the Federal Government will assess an interest charge on the tax deferral each year on a cumulative basis. This option is probably the least attractive one, in our opinion, to small exporters who would still be saddled with DISC and would not have the FSC tax incentives.

The American International Trade Corporation proposal which you introduced would phase out totally the existence of DISC which would change to an AITC.

The second option is available to firms with less than $2.5 million in gross receipts. Under a simplified FSC arrangement, the small exporter would not have to perform economic activities outside of the United States. However, a small FSC would still have to satisfy the requirements for foreign incorporation, would need to maintain an offshore office with appropriate accounting records, and would need to maintain a director to reside abroad.

In general, revenues will qualify as FSC or AITC receipts if certain minimum foreign presence tests and certain economic processes take place outside of the United States. Income would be determined by use of an arm's-length pricing method which is required by GATT rules and by the IRS.

Large exporters will probably find either proposal substantially in line with their present method of operations and will find very few problems in adapting to the new methodology. Small exporters may need to be concerned over how they will comply with the FSC rules and with the foreign presence requirements within the FSC.

The degree of foreign presence requirements is crucial, for small exporters will find difficulty in dealing with very tight foreign presence tests. Recently the Treasury Department issued a statement which gave further details on the degree of foreign presence that would be required for a small FSC. While alleviating most of the concern we had, the FSC proposal still would not be as simple as the AITC proposal.

Mr. Chairman, I think I would like to interject here that in the conversations that we have had internally at NFIB, we believe that anything that can be done to spell out, either in the legislative history—I am not too sure you could go as far as the legislation itself, but certainly in the legislative history—what is expected for the foreign presence test will be of great benefit to small businesses that want to get involved in this area.

Another point worth reviewing is the question of where one draws the line between large and small exporters. The administration distinction is made at $2.5 million in export receipts, while the Senate Finance version was made at $5 million. The 1980 Treasury statistics revealed that exporters with $5 million in assets generated only about 5 percent of DISC income. Further study needs to be done to determine whether the level of $2.5 million or $5 million is high enough to be sufficient incentive to attract new export activities. An export receipt level of at least $5 million may be adequate for purposes of a small FSC designation because it may require a fairly large exporter to comply with the foreign presence and economic processes tests.

The AITC proposal envisions a $10 million threshold for a small AITC. While we have no firm opinion on how high the level needs to be, clearly $2.5 million was too low. A study of the required size of receipts for the small definition needs to be made.

We would tend, I would think, to favor the larger figure. We seem to be somewhat satisfied with $5 million which the Senate Finance Committee readily accepted. I don't think anybody has done any testing yet of the waters over on the Ways and Means Committee to see what level they would be willing to go to. If your staff would be interested in working with us on that, we would certainly be willing to pursue with various members of that committee to whatever level they would be willing to go to in this area.

A third provision of S. 1804 and H.R. 4741, which I consider very innovative and possibly crucial to growth of small business exports, is the proposal to allow multiple ownership of an FSC or AITC. This would allow the occasional exporter and the very small volume exporter to participate in the export tax benefits with little or no up-front investment in money.

A fourth area of interest for small business which the FSC proposal ignores but which is addressed in H.R. 4741 is the desire to include services as an export which would qualify for tax deferred treatment similar to a manufactured product. This provision could be of major importance in addressing our balance of trade, for the service sector is the area of greatest growth for small firms.

Not only is it the area of greatest growth for small firms, Mr. Chairman, but it is the area in which we are creating all the jobs in this country, more and more of our total business is in services every year, and I understand that the report just released by the administration on the state of small business for 1984 indicated that it is already over $30 billion a year in exports in services from the United States. So if you really want to get small firms involved, you should tailor the instrument so that it is dealing with the areas that small firms are producing services in.

The service sector has been and will continue to be the sector of the economy experiencing the greatest growth, and the same is true for the service sectors of the other world economies as well. Small firms with the capabilities to export would be able to compete with larger service exporters only if they had the tax advantages of the AITC. This area needs to be strongly considered for inclusion in any export incentives package, in not now, in the near future.

As I understand it in discussing the items again internally within NFIB, the only problem that we would seem to have in this area would be one of revenue loss, since it is not included right now as an area which is eligible for DISC, and adding this large sector could create problems at a time when Congress is looking for every way possible to reduce the size of the deficit. I think that would be a critical question for NFIB, but we certainly would want to pursue allowing the small service firms to be able to get involved in the expert area.

Those are the main points of the testimony, Mr. Chairman. Again, I would like to thank you for the opportunity to be here. We at NFIB would very much like to work with the subcommittee and the committee to approach the Ways and Means Committee to see

if they can do something when they go to conference on the revenue-raising measures with the Senate to ensure that small firms get a fair shot at this new export incentive legislation.

I will be glad to try to answer any questions that the committee might have. Thank you.

[Mr. Motley's prepared statement follows:]

PREPARED STATEMENT OF JOHN J. MOTLEY III, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

My name is John Motley, Director of Federal Legislation for the National Federation of Independent Business (NFIB). On behalf of the more than 560,000 members of the NFIB, I appreciate the opportunity to comment on tax proposals to foster small business exports.

It is appropriate for this committee to be holding hearings on this subject at this time, for the issue of export incentives is currently being reviewed by the tax writing committees in both the House and the Senate. Designed as a substitute for DISC, the Administration proposal for a Foreign Sales Corporation (FSC) which was recently passed by the Senate Finance Committee would incorporate several important changes in tax incentives for exporting. Congressman Nowak has introduced his proposal for an American International Trade Corporation (AITC) which contains several features to further broaden the appeal and usefulness of export tax incentives for small business.

BACKGROUND

Since 1971, the Internal Revenue Code has provided a special tax incentive for exporters through its Domestic International Sales Corporation (DISC) provisions. This incentive permits an exporter to defer indefinitely payment of Federal taxes on a portion of the firm's export income, thereby providing exporters with an incentive to increase export-related activities. Through the DISC incentives, Congress has hoped to stimulate export activities and reduce our balance of trade deficit while simultaneously increasing employment in export-related activities.

In 1971 as now, our domestic economy suffered from a deficit in our balance of trade accounts, and it was hoped that the DISC incentives would spur American investment into exports. The DISC rules were initially designed to equalize treatment with our foreign trading partners whose exports are directly subsidized.

S. 1804 proposes a replacement of the DISC tax incentive with a new concept entitled the Foreign Sales Corporation (FSC). The FSC will be an incentive proposal much the same as DISC but will also be compatible with our treaty obligations under the General Agreement on Tariffs and Trades (GATT).

Recently releasd statistics by the U.S. Department of Treasury provide an illustration of the extent to which small exporters utilized the DISC incentives. The data reveals that 48% of all DISC returns filed were companies with less than $5 million in assets. Additionally, 30% of all DISCs were owned by small corporations.

While many small firms utilized DISC, many other small exporters declined to take advantage of DISC. In a non-scientific phone survey of NFIB exporters, several reasons were given for the limited use of DISC. They include: insufficient dollar amounts in repeat export activity to warrant establishing a separate DISC subsidiary; technical concerns about how a DISC owner would repatriate tax-deferred dollars, the major incentive provided by the DISC rules; and the complex reporting requirements and qualifications for maintaining a DISC.

Why DISC only partially succeeded in increasing the exports of small business is a question worth exploring at this time. If the Foreign Sales Corporation (FSC) or AITC proposal is to succeed in stimulating exports, the needs of small exporters and potential exporters need to be considered carefully.

CURRENT PROPOSALS

Both S. 1804 and H.R. 4741 propose a dramatically revised and simplified incentive for exporters, both large and small. The provisions in either bill would allow a permanent tax deferral on export earnings because the foreign entity will be incorporated and located outside the United States. Locating outside of the United States means that the entities' earnings are not taxable in the United States. Further, any dividends distributed to parent shareholders will not be taxable if certain requirements are met for export revenues.

The AITC proposal greatly minimizes the degree of foreign presence which would be required and would allow foreign trade zones to be considered as an offshore presence for purposes of foreign presence.

SMALL FSC OR AITC

S. 1804 presents three options for the small exporter. The first option is eligible to exporters with $10 million or less in export receipts, that is, to continue to use the DISC rules with one modification. DISC earnings need not be distributed to shareholders, thereby granting a permanent deferral on total DISC earnings. If this option is chosen, the Federal government will assess an interest charge on the tax deferral each year on a cumulative basis. This option is probably the least attractive one to small exporter, who would still be saddled with DISC and would not have the FSC tax incentives.

The AITC proposal would phase out totally the existence of DISC which would change to an AITC.

The second option is available to firms with less than $2.5 million in export receipts. Under a simplified FSC arrangement, the small exporter would not have to perform economic activities outside the United States. However, a small FSC would still have to satisfy the requirements for foreign incorporation, would need to maintain an offshore office with appropriate accounting records, and would need to maintain a director to reside abroad.

In general, revenues will qualify as FSC or AITC receipts if certain minimum foreign presence tests and certain economic processes take place outside of the United States. Income would be determined by use of an arm's length pricing method which is required by GATT rules and the IRC.

Large exporters will probably find either proposal substantially in line with their present method of operations and will find very few problems in adapting to the new methodology. Small exporters may need to be concerned over how they will comply with the FSC rules and with the foreign presence requirements within the FSC.

The degree of foreign presence requirements is crucial, for small exporters will find difficulty in dealing with very tight foreign presence tests. Recently the Treasury Department issued a statement which gave further details on the degree of foreign presence that would be required from a small FSC. While alleviating most of the concern we had, the FSC proposal still would not be as simple as the AITC proposal.

Another point worth reviewing is the question of where one draws the line between large and small exporters. The Administration distinction is made at $2.5 million in export receipts, while the Senate Finance version was made at $5 million. The 1980 Treasury statistics revealed that exporters with $5 million in assets generated only about 5% of DISC income. Further study should be done to determine whether the level of $2.5 million or $5 million is high enough to be a sufficient incentive to attract new export activity. An export receipt level of at least $5 million may be adequate for purposes of a small FSC designation because it may require a fairly large exporter to comply with the foreign presence and economic processes tests. The AITC proposal envisions a $10 million dollar threshold for a small AITC. While we have no firm opinion on how high the level needs to be, clearly $2.5 million was too low. A study of the required size of receipts for the small definition needs to be made.

A third provisions of S. 1804 and H.R. 4741 which I consider very innovative and possibly crucial to growth of small business exports is the proposal to allow multiple ownership of a FSC or AITC. This would allow the occasional exporter and the very small volume exporter to participate in the export tax benefits with little up front investment in money.

A fourth area of interest for small business which the FSC proposal ignores but which is addressed in H.R. 4741 is the desire to include services as an export which would qualify for tax deferred treatment similar to a manufactured product. This provision could be of major importance in addressing our balance of trade, for the service sector is the area of greatest growth for small firms.

The service sector has been and will continue to be the sector of the economy experiencing the greatest growth, and the same is true for the service sectors of the other world economies as well. Small firms with the capabilities to export would be able to compete with the larger service exporters only if they had the tax advantage of the AITC. This area needs to be strongly considered for inclusion in any export incentives package, if not now, in the near future.

CONCLUSION

The AITC proposal in H.R. 4741 successfully presents the needs and rationale for assisting the small exporter in dealing with foreign trade incentives. In my opinion the AITC legislation would result in an emphasis of new export activity by small companies.

While being a definite improvement over DISC, the FSC proposal, specifically the small FSC proposal, would benefit if several of the AITC proposals were merged into it. Already progress has been made in the Finance Committee bill which raised its threshold for a small FSC to $5 million. Even though all of the AITC proposals may not be adopted this year, certainly there is room to work for future changes.

Mr. NOWAK. John, thank you very much.

I think you make an excellent point when you talk about the growth only in the general small business area to create jobs, but also the opportunities in consulting and so-called small service industry that is out there and growing very rapidly. Very few of those firms are even thinking about looking at overseas markets, although they may really have services that would be very attractive, especially overseas. When you look at the sophistication level of some of the countries that are exporting to us, certainly we could be exporting technical services and all kinds of other consulting marketing services to them. Yet, it is probably not done because it is just not within the present structure for a small business to look overseas. Everything we have tried to do in AITC was to put this together and form an incentive that really will make a difference.

When you look through the Tax Code, there are going to be loophole closings of all kinds. But I think the whole structure here as we start the change has to be reacting to what really is going on in the world. You know, you hear people say, "Well, we don't want government involved with businesses," but when we talk about an overt spending program where you talk about a "tax incentive," both are going to have some revenue implications.

I think that has to be viewed in the overall context of what the real incentive is going to be—not as this economic structure was 40 years ago or 30 years ago—but how do we now really compete in this global economy? Do we let all of our businesses sit out there on their own? The ultimate would be to remove all DISC legislation and wipe it right off the boards. But I think it was put in for the purpose of trying to expand exports. I don't have the figure of what our deficit was in 1971 when this was put in because of the tremendous trade deficit, but I will bet you it was nowhere near the kind of dollars we are talking today, even if you make adjustments for inflation through this period.

So we let other things just pull our economy forward here in our legislation. As we try to make up for another problem, I don't want to see small business again left on the short end of this. I think, really, if there are markets, if there are abilities to export, we better make them as competitive as everybody is making them throughout the world.

Mr. MOTLEY. Mr. Chairman, I believe it is a truism out there that our largest firms are exporting as much as they possibly can right now. They have been involved in this area for decades. They know the lucrativeness of the markets and they are doing whatever they can. So if we are ever going to increase the overall

volume of exports, it has got to be done from the medium and small business sector.

So your points are well taken. If the Government is serious about reducing the trade deficit that way, then I think they are going to have to provide incentives equal to those they provide to larger firms.

Mr. NOWAK. The point being, John, as we look at this, you are right. Large businesses, I am sure, are exporting everything they can with the structure as it is presently situated.

But with all that exporting, you are coming up with $60.6 billion in deficits this year. Hopefully, some of that can be taken out in this small business area.

Let me turn to my colleague, Jim Olin.

Mr. OLIN. Thank you, Mr. Chairman.

Mr. Motley, you have referred to the issue of possible loss of tax revenue. I guess it is obvious that if we are not exporting much now in this sector, there isn't any revenue in that sense coming in.

Mr. MOTLEY. That is true.

Mr. OLIN. So we are not talking about cutting revenue, we are actually talking about the prospect of increasing revenue.

On that issue, do you have any kind of fix that if this size threshold was kept at $5 million, what kind of revenue leverage might we be talking about here?

Mr. MOTLEY. Would that be including services, Mr. Olin?

Mr. OLIN. Let's say without services.

Mr. MOTLEY. Without services, as I understand it, Treasury says that the bill is revenue neutral. I find that hard to believe since we are now going to full forgiveness on it, but I guess it is something that Treasury favors and they are trying to put the best light they can on it.

They have indicated to the Finance Committee that the proposal, as is drafted now, is revenue neutral.

Mr. OLIN. If you raised the size to $10 million, would it alter that particularly?

Mr. MOTLEY. I don't see where it would alter it at all.

Again, the only thing it would do would possibly get more firms to get involved in it, and there may be a revenue loss down the road, but there could be increased economic activity and greater taxes to offset that.

Mr. OLIN. So the revenue question, you are saying——

Mr. MOTLEY. The revenue is at the top.

Mr. OLIN. Really is not the critical issue here?

Mr. MOTLEY. No, not in this proposal, not at all.

There is a feeling, though, if you would add services, since it basically represents or is getting close to representing a third of the economic activity in the economy, that you would than change the figures somewhat and cause greater revenue loss. I think we would still support that. I just don't know if we could be successful in convincing some of the other people on the tax-writing committees that it should be done that way.

Mr. OLIN. Do you have any order of magnitude you can attach to that if you added services, what kind of annual revenue?

Mr. MOTLEY. No. But we could try to work out the figure. It would be somewhat of a guesstimate, but if you would like, we

could sit down and try to come up with what we thought would be a figure based upon the relative size or importance of the two sectors in the economy.

Mr. OLIN. I would think that you are right, that there would be substantial export opportunities in services.

Mr. MOTLEY. Another option here would be only to allow the FSC for firms under $10 million in services, and then phase it into the larger firms later on, to go to sort of a stepped phasein of the advantages. Do small business first, and if it seems to be working fairly well, then accept the larger revenue loss later on, hopefully when the deficit is reduced somewhat.

Mr. OLIN. That is an interesting possibility.

Mr. MOTLEY. That is a tactic that is adopted by the Ways and Means Committee all the time in whatever they do.

Mr. OLIN. You said that further study is needed on this question of size. Is your organization prepared to help on that question? Who is the best one to deal with the evaluation of whether the size ought to be $5 million or $10 million or some other number?

Mr. MOTLEY. I think that probably the most data that is available right now is through the Commerce Department. But we do have, I believe, scheduled around midyear an exporting survey which we are going to be sending out to about 20,000 of our members to try to get some more information. This question certainly could be one which we could include.

But if you wanted an immediate answer, I would probably turn to the Office of Advocacy at SBA and to the Department of Commerce Bureau of the Census to see if they could come up with information.

Mr. OLIN. Fine. Thank you very much.

Thank you, Mr. Chairman.

Mr. NOWAK. Thank you.

John, we will certainly be in touch with you on this as we move forward. I think that once we get through with this record and expose all of this testimony to the other committees, Ways and Means especially, who are going to be dealing with this, we will be able to very shortly thereafter sit down and try to make some sense.

I really believe that this could be a very critical factor. The more people we have exposed to foreign trade zone prospects, the more and greater response we receive as to their possibilities of getting involved with the DISC at this point in time. In addition, looking to the future, because of that association with the foreign trade zones, to try to develop other sources of export in areas they have never come in contact with, even though they may have been in business for 15 or 20 years. I think it could work to everyone's benefit.

I certainly want to get that message to them and, hopefully, have them look at this as an alternative to the small business sections they have over in the Senate bill.

Mr. MOTLEY. I think your approach of keeping it as simple as possible is absolutely the only one that will work. Anything that is complicated automatically turns off an owner of a small business. He just doesn't want to deal with it.

Mr. NOWAK. Especially if you tell him he has to go overseas to Granada or someplace like that.

Thank you very much. We will certainly be looking forward to working with you after we get this record together.

Mr. MOTLEY. Thank you, Mr. Chairman.

Mr. NOWAK. Our next witness will be William Strecker, Jr., from the National Ocean Industries Association. Mr. Strecker, if you will come forward.

Mr. Strecker is the executive vice president for administration, the Porta-Kamp Manufacturing Co., Inc., in Houston, Tex. Mr. Strecker has been with the corporation for about 9½ years. The corporation designs and manufactures modular or remote offshore housing facilities for energy, construction and related industries. He is also director of the DISC of Porta-Kamp.

We want to welcome you before the subcommittee. We will just let you know that the excellent testimony that you have prepared will be submitted in the record in its entirety.

TESTIMONY OF WILLIAM STRECKER, JR., EXECUTIVE VICE PRESIDENT FOR ADMINISTRATION, PORTA-KAMP MANUFACTURING CO., INC.

Mr. STRECKER. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I am happy to be here today appearing on behalf of the National Ocean Industries Association, which is a national trade association and acts as the administrative and legislative spokeman for over 485 member companies. It draws its membership from manufacturing, producing, service, supply and support companies—large and small—which are involved in marine, offshore or ocean related work. Approximately 40 percent of the association's membership is comprised of firms which are classified as small business, Porta-Kamp being one of these.

Because of the international scope of the association's membership, we are keenly interested in export incentives. I am sure we would all agree that any action that increases exports would be of immeasurable benefit to the Nation's economy. However, no program will help the U.S. exporter if he cannot be competitive in today's world marketplace.

As an example, because of the dollar's present high value, as well as the protectionist philosophy of many nations, our company has recently been told by various foreign clients that our pricing must be at least 20 percent lower than that of our foreign competition in order to be given even minimal consideration. Our company has learned from almost 30 years of experience, however, that if American firms are competitive, the majority of other obstacles to foreign trade can be overcome.

Clearly, a key factor to enhance the competitive position of American business would be one of tax incentives. From my point of view as an administrative executive in a small manufacturing company, there are several aspects of any legislative plan that must be considered in addition to the tax benefit itself.

First, the program should foster production of goods within the United States. Second, it must be a continuing policy, one that may be relied upon by business in their long-range financial planning. Lastly—and this point has already been made by other witnesses—

the provisions of any legislation must provide simple and easy administration; if not, the additional overhead burdens may well discourage the small businessman from the export marketplace altogether.

As we review the legislation introduced which would replace DISC with foreign sales corporations, we find several points that are particularly onerous to small business: First, the requirement that the FSC be incorporated under the laws of a foreign country or a U.S. possession; second, the necessity for a minimum of one nonresident member on the board of directors of the FSC; third, the foreign management and the foreign economic process test, which are an integral part of FSC.

These requirements are so burdensome for smaller companies, many may completely give up the idea of FSC or exporting altogether.

Although this legislation makes an attempt to exempt small FSC's from certain of the foreign presence and foreign economic processes, this relief is not enough to offer any real degree of encouragement to small firms.

It is with optimism we welcome the proposals contained in H.R. 4741. The proposed establishment of American international trade corporations, and the special rules for small businesses are a step in the right direction. We make the following comments in this regard.

The AITC proposal, as well as the FSC plan, would treat accumulated deferred DISC income as previously taxed income and, therefore, it would not be taxed upon actual distribution. This would relieve current DISC's from a liability on previously deferred income. We feel this is an element of primary consideration which should be included in any legislation.

As I have highlighted previously, there are many administrative and control problems with the propose FSC, particularly for small business. We feel certain of these have been corrected by the AITC proposal.

Specifically, the AITC proposal allows for a 5-year phaseout of small DISC's so as to allow ample time for compliance. We feel this is an excellent idea and should be retained in AITC or incorporated into FSC proposals.

The AITC proposal allows the export corporation to be created in a foreign trade zone. We feel this would greatly simplify the administrative and control problems for most small businesses. Since there are some 96 foreign trade zones located throughout the United States, this idea would offer the small businessman a viable alternative. We encourage and support this provision.

The AITC proposal would exempt small firms from maintaining an office or books and records overseas, and from having a nonresident director. This is most desirable, since these requirements are not only costly and nonproductive, but would create unnecessary barriers for the small businessman.

Under FSC, only very small businesses would be exempt from the foreign management and economic process requirements. We feel this should be increased to at least $10 million, as proposed in the AITC proposal.

However, today we would also like to suggest a different concept, that being to eliminate altogether the monetary ceiling on gross export receipts for either a small FSC or a small AITC, and simply allow any firm that qualifies as a small business under the regulations established by the Small Business Administration to be considered a small AITC or FSC. We feel that then more small businesses would be encouraged to enter the export market if their tax incentives could continue to parallel their growth without a ceiling on gross export receipts. Hopefully, the GATT Council will direct its attention to the broad aspects of any new program, and will not be overly concerned with exemptions that are granted to small businesses.

Last, I would like to point out that there may be substantial legal problems with the foreign incorporation requirements of either FSC or AITC. There is the possibility that disputes will have to be resolved in a court within the jurisdiction where the FSC or AITC is formed, since there is the requirement that contracts be made directly by or with the foreign entity. These laws may be substantially different from those of the United States, and could result in extremely costly litigation, particularly for the small businessman who may not have the sophistication or expertise to keep abreast of these foreign laws. This is yet another reason for increasing to at least $10 million, as proposed by the AITC proposal, the exemption from the foreign management and economic process requirements.

We also feel there is some question of tax equity in the present proposals compared to the current DISC. Details of this are highlighted in our prepared statement.

My remarks today have centered in the impact of FSC or AITC proposals on the export potential of America's small businessman. We hope that our comments and suggestions be considered as the Congress continues the legislative processes on these various packages.

In conclusion, we would stress that any program which is structured to conform with GATT would also be an effective stimulant, particularly for the small businessman, to our export trade.

Mr. Chairman, on behalf of the National Ocean Industries Association, we appreciate the opportunity to present this statement.

[Mr. Strecker's prepared statement follows:]

PREPARED STATEMENT OF WILLIAM STRECKER, JR., EXECUTIVE VICE PRESIDENT FOR ADMINISTRATION, PORTA-KAMP MANUFACTURING CO., INC.

Mr. Chairman and Members of the Subcommittee, I am William Strecker, Jr., Executive Vice President for Administration of Porta-Kamp Manufacturing Company, Inc. in Houston, Texas. I am also a Director of Porta-Kamp DISC, Inc. Our firm's primary business is the design, manufacture and sales of remote area housing facilities, for clients in energy, construction and related industries. Accordingly, approximately ninety-five percent of our sales volume has traditionally been for the export market.

I am appearing today on behalf of the National Ocean Industries Association (NOIA). NOIA is a national trade association, which serves as the legislative and administrative spokesman for its 485 member companies. NOIA draws its principal membership from manufacturing, producing, service, supply and support companies—large and small—which are involved in marine, offshore or ocean related work. Approximately 40% of the association's membership is comprised of firms which are classified as small business, Porta-Kamp being one of these.

Because of the international scope of the association's membership, we are keenly interested in export incentives. I am sure we would all agree that action which increases exports, would be of immeasurable benefit to the nation's economy, primarily the creation of new job opportunities and the reduction of staggering U.S. trade deficits. However, no program will help the U.S. exporter if he cannot be competitive in today's world market-place. As an example, because of the dollar's present high value, as well as the protectionist philosophy of many nations, our company has been told recently, by several foreign clients, that our pricing must be at least 20% lower than our overseas competition, in order to be given even minimal consideration. However, Porta-Kamp has learned from almost thirty years of experience, that if American firms are competitive, the majority of all other obstacles to foreign trade can be overcome.

Clearly, a key factor to enhance the competitive position of American business is that of tax incentives. Over the past years, Domestic International Sales Corporations (DISC) have offered, to a great extent, such tax incentives, while at the same time providing an underlying basis for growth of export sales. For example, at Porta-Kamp, in the five year period following the establishment of a DISC, our export sales increased 640%. As responsible businessmen, we do, however, recognize the continuing and increasing pressure against DISC from the other parties to the General Agreements on Tariffs and Trade (GATT), and specifically the objections of the European community. Accordingly, our attention has been directed to the alternatives now before the Congress.

From my point-of-view, as an administrative executive in a small manufacturing company, there are several aspects of any legislative plan, that must be considered in addition to the tax incentive itself. First, the program should foster production of the goods within the United States. Second, it must be continuing policy, one that may be relied upon by business in their long range financial planning. Lastly, the provisions of any legislation must provide for simple and easy administration; if not, the additional overhead burdens may well discourage the small businessman from the export market place. The U.S. Department of Commerce has estimated that there are some 20,000 small firms in this country that have the potential to market overseas on a competitive and profitable basis, but do not because of various barriers. Any tax incentive program, which replaces DISC, must consider the concerns of small business, or this vast sector of the American economy will be restrained from making a significant contribution to U.S. exports.

As we review the legislation introduced, which would replace DISC with Foreign Sales Corporations, (Senate Bill S. 1804 and the companion House Bill H.R. 3810), we must address several points that are particularly onerous to small businesses.

First, the requirement that the FSC be incorporated under the laws of a foreign country or a U.S. Possession.

Second, the necessity for a minimum of one non-resident member on the Board of Directors of the FSC.

Third, the foreign management and the foreign economic process test, which are an integral part of FSC.

These requirements are so burdensome for smaller companies, that many may completely give up the idea of forming a FSC.

Although this legislation makes an attempt to exempt small FSC's from certain of the foreign presence and foreign economic processes, this relief is not enough to offer any degree of encouragement to most small firms. Additionally, only very small businesses (up to $2.5 million in gross export receipts) would qualify for these exceptions.

Therefore, it is with optimism that we welcome the tax incentive proposals contained in House Bill, H.R. 4741, as introduced by the Hon. Henry J. Nowak. The proposed establishment of American International Trade Corporations (AITC's), and the special rules for small AITC's are a step in the right direction. We would offer the following comments in this regard:

1. The AITC proposal, as well as the FSC plan, would treat accumulated deferred DISC income as previously taxed income, and therefore it would not be taxed upon actual distribution. This relieves current DISC's from a liability on previously deferred income. This is an element of primary consideration, which should be included in any legislation.

2. As highlighted previously, there are many administrative and control problems with FSC, particularly for small companies. Certain of these are corrected by the AITC proposal, specifically:

(a) The AITC proposal allows for a five year phase-out of small DISCs (less than $10 million gross receipts) so as to allow ample time to comply. This is an excellent idea and should be retained in AITC or incorporated into FSC.

(b) The AITC proposal allows the export corporation to be created in a foreign trade zone. This would greatly simplify administrative and control problems for most small businesses. Since there are some 80 FTZ's located throughout the U.S., this idea offers a viable alternative for the small business man. We encourage and support this provision.

(c) The AITC would exempt small firms from maintaining an office or books and records overseas, and from having a non-resident director. This is most desirable, since these requirements are not only costly and nonproductive, but would create unnecessary barriers for small businesses to form an export subsidiary. Unless these requirements in the FSC proposal are eliminated for smaller businesses, we suggest there be a credit to small companies to offset the cost of compliance.

(d) Under FSC, only very small businesses ($2.5 million in gross export receipts) would be exempt from the foreign management and economic process requirements. This should be increased to at least $10 million as incorporated in the AITC proposal. With this increase, over 92% of gross export receipts would remain covered by the foreign economic process and foreign management requirements, which should certainly be adequate to satisfy our GATT critics. It would at the same time lighten the overhead burden of a larger number of small companies. However, we would also suggest a different concept, that being to eliminate altogether the monetary ceiling on gross export receipts for small FSC's or AITC's, and simply allow any firm that qualifies as a small business under the regulations, as established by the Small Business Administration, to also be considered a small AITC, or small FSC. We feel more small businesses would be then encouraged to enter the export market, if their tax incentives would continue to parallel their growth, without a ceiling on gross export receipts. Hopefully, the GATT Council will direct its attention to the broad aspects of any new program, and will not be overly concerned with exemptions that may be granted small businesses.

3. There may be substantial legal problems with the foreign incorporation requirements of either FSC or AITC. There is the possibility that disputes will have to be resolved in a court within the jurisdiction where the FSC or AITC is formed, since there is the requirement that contracts be made directly by the foreign entity. These foreign laws may be substantially different than those of the U.S., and this could result in extremely costly litigation, particularly for the small company who often may not have the sophistication or capability to continuously keep abreast of changing foreign laws. This is yet another reason for increasing, to at least $10 million, the exemption from the foreign management and economic process requirements.

4. Finally, there is also the question of tax equity in the present proposals compared to the current DISC. The November 18, 1983 Joint Committee on Taxation paper gives calculations on Page 43, which show small DISC's paying a 36.2% effective tax rate and large DISC's and proposed FSC's paying a 38.2% tax rate. The implication is, that there is only a 2% difference between small DISC tax rates and FSC rates. In actual practice this is not always the case.

The current proposals require a FSC or AITC to have the same taxable year as its majority shareholder. A DISC does not have this requirement. in actual practice, many DISC's are set up with a tax year one month later than that of the parent, thereby creating in effect, an additional eleven month tax deferral. By carefully timing of certain export transactions near the end of a DISC tax year, and by use of this eleven month deferral, most new DISC's formed by small growing companies, are able to actually have an effective tax rate of 26.5% on exports. The difference between 26.5% and 38.2% is most significant.

While the Joint Committee on Taxation has acknowledged that the FSC proposal places relatively more emphasis on larger slower-growth companies than on smaller faster-growth companies, they have underestimated greatly the degree of difference. The FSC proposal represents a 44% tax increase on exports for small growth companies with recently formed DISC's. This appears unequitable and should be modified so that the tax on exports under FSC or AITC would be approximately the same as that under DISC. We feel this could be accomplished, to a great extent, by eliminating the proposed requirement that the taxable year of a FSC or AITC conform to that of its majority shareholder.

My remarks today have centered on the impact of the FSC or AITC proposals, on the export potential of America's small businessman. We hope that our comments and suggestions will be carefully considered as the Congress continues the legislative processes on these various packages. In conclusion we would stress, that any program which is structured to conform with GATT, will also be an effective stimulant, as a tax incentive, to our export trade.

Mr. Chairman, on behalf of the National Ocean Industries Association, we appreciate the opportunity to present this statement.

Mr. NOWAK. Thank you very much for your statement. I think it is a well reasoned one.

We have talked about this trade deficit before in 1970, and one figure was mentioned. If you use the figures that include shipping cost and insurance—I want to get back to this and put this in the record—we had a horrendous trade deficit in 1971—I believe these figures are correct—of $5.3 billion. Adjusted, I guess, the 1983 figures with the shipping costs would be about $69 billion. If you include just the value of the goods, it is $2.6 billion in 1971, and $57 billion in 1983.

So we do have quite a differential. It certainly is cause for concern. We had concern in 1971, and it certainly is a calamity now, in looking at the size of this differential.

Let me ask you, can you give us an approximation of what you had to spend when you set up the DISC incentive initially?

Mr. STRECKER. It was a very minimal amount. I do not have any exact figures, Mr. Chairman, however, because it was incorporated under the laws of the State of Texas, it was a relatively simple procedure. Obviously, if relief is not granted to the small businessman with regard to foreign incorporation, as is proposed particularly in FSC, it is going to be extremely expensive. I think we all know foreign legal services cost more than American services and you need foreign accountants, et cetera.

I can state for the record that we maintain one small foreign corporation, and it costs us almost $20,000 a year, which may not sound like much, but it is for a small businessman, simply to maintain the accounting and legal records in a foreign country of this one little small entity that does no business there other than the fact that it needs to be incorporated there and must meet those statutory requirements.

Mr. NOWAK. You mentioned in your testimony that the 5-year phaseout period for the DISC's is a good idea. How would you think that will affect your organization directly?

Mr. STRECKER. In today's world marketplace, if we had a crystal ball and knew exactly where it was going to be within the next 5 years, we certainly could select to either be a FSC or AITC and incorporate in a foreign country if we thought we were going to do millions of dollars of business.

At the present time, with the instability in the world economy, I think our corporation would utilize the 5-year phaseout of DISC and simply remain a DISC until such time as we could determine where our marketplace was going to be and what was going to happen. If there was a significant upturn and we were going to be a large volume exporter, as we have been in the past, we would need to incorporate foreign and meet the various requirements.

Mr. NOWAK. Under the present proposed legislation, where would you think you would establish?

Mr. STRECKER. If the proposals as set forth in AITC were incorporated into the final legislative package, we would most certainly incorporate within a foreign trade zone within the United States. We believe we would still be classified as a small AITC at that time and would avail ourselves of that excellent opportunity.

Mr. NOWAK. The elimination of the ceiling that you had mentioned in your written and your oral testimony—I wonder if you could elaborate a little bit on that, where you think the benefits would then flow from?

Mr. STRECKER. I believe that, under the FSC proposal originally, the ceiling was $2.5 million, I now understand it is $5 million; under the AITC proposal it is $10 million.

Mr. NOWAK. If I might interject, that figure has been suggested to me as much too low for some of the firms that have the ability to expand, and yet are concerned if they had their limit, should they go over it and take on the added burdens.

Mr. STRECKER. Yes. If the proposed legislation simply provided that a small business under that act was any business classified as a small business by the SBA, it would open up an infinite realm of excellent opportunities for companies. The majority of us, the manufacturing companies, as long as we have 499 or less employees—there are certain exceptions, but the majority in the manufacturing industry—our growth would almost be limitless within the export market and still be classified as a small FSC or small AITC.

As I stated, hopefully the GATT members would look at the big picture and not concentrate on what relief may have been given for the small American businessman, and the small exporter would not see a limit on his growth. He would not see a $5 million or $10 million cap on his growth. If he knew that in the corporate structure he set up, as long as he was growing and continuing to export, his tax incentives would parallel that growth. If he exceeded the small business size as defined by the SBA, I feel the firm would be large enough they wouldn't need the help offered here.

Mr. NOWAK. Let me turn to another member of the subcommittee who has also expressed a great deal of interest in this, and has spent some time with it. In fact, his background as a tax attorney in the private sector has given him an especially keen insight into this whole area—my colleague, Robin Britt from North Carolina.

Mr. BRITT. Thank you, Mr. Chairman.

I appreciate your testimony and your addressing the issue of foreign trade zone as a local corporation makes a lot of sense to me. In earlier hearings, we talked about having to go offshore, and this would make an awful lot of sense if that could be incorporated.

I would like to sort of probe a little bit beyond just your testimony because, in my estimation, the crisis that we are facing and has not yet been identified fully is these trade deficits and the trend that we are approaching.

As you try to enhance exports—in addition to obviously a potential removing the tax incentives on a DISC—what are the major barriers that you face in exporting your products, and what competitive advantages, governmental or otherwise, do you see foreign manufacturers or foreign business enterprises having relative to your advantages?

What I am trying to do is to look at invisible barriers, look at competitive advantages, that foreign competition has that we don't have.

Mr. STRECKER. There are several, and particularly at the moment the high strength of the dollar. I mentioned this at the beginning of my testimony, and I just cannot stress it enough. Right now, the

strength of the dollar, however proud it makes us as Americans, as exporters hurts, and it hurts badly. We have customers with no other influence involved other than the relationship of the dollar to the mark or the franc or the pound, who simply cannot afford to buy our product no matter how much they like it and want it.

I would say the second is this protectionistic attitude by many of the nations, many of whom are the most vocal critics of DISC. To be specific, if a French general contractor gets a contract, let us say, in Algeria or anywhere in Africa or in the Middle East, he is going to procure his housing, his construction equipment, and all of the machinery he needs from France because the Central Government of France will simply not allow him to export francs for dollars. They just won't approve the letter of credit transaction through the central bank. Therefore, you have that protectionistic philosophy.

There are other things which I feel are indirectly hurting the small businessman in the flow-through. By that, I mean big business is not getting business because of direct assistance of certain foreign governments in their lending programs and in their aid programs which allow their large contracting and service companies to get the work.

Mr. BRITT. Are you talking subcontracting to these companies, directly or indirectly from government, or what?

Mr. STRECKER. What I would say, for example, the central bank or the export bank of one of our European allies would make a loan to a Third World country, and they would make that loan at the minimum GATT interest rate that they could charge under the General Agreements on Tariff and Trade. At the same time, that government may give the same Third World nation an equal amount of money which, in effect, reduces the interest rate on that loan to 50 percent.

The proviso of all of that is that the business is restricted to that French, or Italian, or British, or German, or Dutch firm, whatever the case may be.

Then when you start eliminating your major American contractors from that sector of the marketplace, they are not buying supplies, goods, or services from firms such as ours, the small businessman.

That last example doesn't impact our firm directly, because we don't work on that high a scale of politics, so to speak. But it affects us directly when the major contractors in America don't have work, and they are flat on their backs right now. Then they don't need any housing for their people overseas.

I would say those are the three things, in my personal opinion, that are hurting us.

Mr. BRITT. What would you say, in sort of a summary fashion, would happen if the foreign sales corporation approach versus the AITC approach—in sort of a nutshell, what sort of an effect would that have on the small businesses exporting?

Mr. STRECKER. If the foreign service corporation legislation as now proposed is passed, I feel—and from the point of view of our own business—we would probably say why bother. If we have to spend that amount of money to set up a foreign corporation, to have a foreign director, to have foreign books, or to be a small FSC,

we can only have a tax benefit up to $2.5 million, or now $5 million, is it worth it? I would dare say a lot of other small businessmen would probably have the same opinion.

Mr. BRITT. Basically what you are saying is, to go that route is to, in effect, remove the incentives that the DISC program was intended to provide; whereas, the AITC approach would retain those incentives, it would retain an interest in exporting on the part of small business because of the tax benefits?

Mr. STRECKER. Yes; certainly any program can be improved. We made some comments today concerning the AITC proposal. But as stated in my comments, the AITC proposal is far more palatable, far more beneficial, and far more simple for the small businessman to get into and administer.

Mr. BRITT. You say DISC's are a major stimulant to small business export?

Mr. STRECKER. I believe they certainly have been over the past years. They have been to our firm.

Mr. BRITT. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you very much, Mr. Britt.

Mr. Strecker, thank you very much for your very comprehensive and complete statement. Certainly your addition to the record is going to be very much appreciated by not only the members who will have an opportunity now to see this in context with all the other testimony, but also, of course, the impact upon the Ways and Means Committee. Someone did mention that perhaps we have already made an impact by filing the AITC bill and giving an alternative for the Senate to look at it.

Raising the $2.5 to $5 million has been a step, but I still feel that, if this thing is going to really provide any kind of an incentive to export, we are going to need much more, and your line of rational testimony will aid us, I think, in that process.

Thank you very much for your time and attention.

Mr. NOWAK. I would like now to call the National Association of Foreign Trade Zones, Robert Chancler, the executive director; and he will be accompanied by Stephen Creskoff, who is an attorney from Harris, Berg & Creskoff, in Washington, D.C.

Mr. Chancler has been the executive director of the association since May 1983. He has been very active in international trade policy, especially in the DISC area, for many years.

Mr. Creskoff is a legal expert on customs law and foreign trade zones. He serves as cochairman of the association's government regulations committee.

I would like to have them joined by Mr. George Keitner, who is also here as executive director of Foreign Trade Zone, No. 23, located in Buffalo, N.Y. He is also president of the George Keitner & Associates, Inc., which is a customs and free trade zone consulting firm.

We would like to welcome both your presence here. We will go through each testimony, and then perhaps have the opportunity to jointly ask some questions.

Mr. Chancler, you may start.

TESTIMONY OF ROBERT CHANCLER, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF FOREIGN TRADE ZONES; ACCOMPANIED BY STEPHEN CRESKOFF, ATTORNEY

Mr. CHANCLER. Thank you for inviting us today, Mr. Chairman.

I would like, with your permission, since our statement is brief, to read the statement.

Mr. NOWAK. That would be fine.

Mr. CHANCLER. The National Associaton of Foreign Trade Zones is a trade association which represents over 200 companies that are involved in the foreign trade zone program. These include zone grantees, operators, users of zone facilities, municipalities, port authorities, economic development consultants, attorneys, and other development specialists. The membership profile extends from very large corporations through a number of small businesses. In fact, a recent NAFTZ survey estimated that 78 percent of the companies using foreign trade zones were classified as small business.

I might add that this survey was taken in conjunction with the review of the foreign trade zone program by the International Trade Commission at the request of Chairman Rostenkowski of the Ways and Means Committee.

There are presently 97 foreign trade zones authorized, and these are located in some 40 States. The Foreign Trade Zones Board in the Department of Commerce, which reviews foreign trade zone applications, estimates that almost all States will have some level of FTZ activity within the next year.

The present Domestic International Sales Corporation tax deferral program represents one of few assistance incentives provided by the Government to help U.S. companies in developing their export potential. This is in sharp contrast to the range of subsidies, rebates of taxes, low-interest loans, and other assistance programs provided by foreign governments to their exporters.

Because of the alleged inconsistencies of the DISC with the provisions of the General Agreement on Tariffs and Trade—the GATT—the administration has proposed a substitute for the DISC in the form of a foreign sales corporation. Under the proposal, an FSC would have to be incorporated offshore and conduct a specified level of export activities through its offshore entity. Small business exporters, classified in the Senate Finance Committee passed bill as those with less than $5 million of export sales, would have the option of retaining the DISC and paying an interest charge on the tax deferred or incorporating and conducting export activities offshore.

If the purpose of a DISC substitute is to insure compatibility with the GATT and still provide assistance to U.S. exporters in being competitive in world markets, then the proposed alternative should not result in increased administrative and organizational costs to former DISC users. This is particularly true in the case of small business exporters among the 8,600 companies who filed DISC tax returns in 1981, and the over 15,000 firms who have made DISC elections in 1982. Moreover, any alternative should provide net benefits which are at least equal to the present DISC program.

H.R. 4741, which provides the option for small business exporters to organize and locate their export entity within a U.S. foreign trade zone, is a much more reasonable alternative to assist small businesses in retaining their DISC benefit without incurring additional administrative and organizational costs. An FTZ, which is considered located outside the customs territory of the United States, in effect, would accomplish the same objective as offshore incorporation and activity. In addition, the simpler the proposal, the more likely it will serve to encourage more small businesses to enter the export market. Conversely, the more complex the DISC substitute, the more likely it will serve to discourage present DISC users and curtail small businesses in entering export activities.

I would like to thank you for this opportunity to present this statement. After Mr. Keitner and after Mr. Creskoff, I would certainly be pleased to answer any questions you may have.

Mr. NOWAK. Thank you very much.

Mr. Creskoff, do you have any comments?

Mr. CRESKOFF. No; I have no comments, thank you.

Mr. NOWAK. Thank you very much.

Mr. Keitner.

TESTIMONY OF GEORGE K. KEITNER, PRESIDENT, GEORGE K. KEITNER & ASSOCIATES, INC.

Mr. KEITNER. Mr. Chairman and members of the committee, my name is George Keitner.

I am not a tax expert, but I have over 40 years of experience in the field of international transportation and commerce, customs procedures, and in the field of free ports and free trade zones. I am honored to be invited to testify before this committee.

According to the Small Business Administration estimation, over 30,000 small manufacturers are capable of exporting their products. They are capable, but they are not doing it. Why? Basically, beause they don't know how to do it. The export procedures are complex, the regulatory requirements are lengthy and, so, simply stated, they are afraid to export their products.

The small business community is concerned about the excess paperwork requirements, the complicated regulations, lack of expertise and, naturally, the unknown and most overestimated expenses involved in exportation.

At the General Agreement on Tariffs and Trade Council October 1982 meeting, the U.S. Trade Representative William Brock announced that the administration would propose an alternative to the current domestic international sales corporation tax incentives because of complaints made by the members of the Council that DISC violates the General Agreements on Tariffs and Trade. This alternative must be legal from the GATT Council viewpoint and have to be usable for small businesses. This alternative should be the International Trade Tax Act of 1984, which was presented in the House of Representatives on February 2, 1984.

Among other provisions, the International Trade Tax Act of 1984 would merely require a small firm to set up a small American international trade corporation which is created or organized under the laws of a foreign country. As an alternative, the small

AITC could be created or organized in any foreign trade zone. This alternative would alleviate the psychological and financial burden on the small business of incorporating overseas. Further, small business firms would have the option of participating on a joint basis, or in a joint trading company venture, as shareholders in an American international trade corporation.

In the United States, the term "foreign trade zone" is used to designate the free trade zones facilities operating in this country. By definition of the U.S. Department of Commerce, it is an isolated, enclosed—fenced—policed area under the supervision of the designated agency—Customs—operated as a public utility by a corporation, either public or private. It is in, or adjacent to, a port of entry, without a resident population, furnished with necessary facilities for loading and unloading, for the storage of goods, and for reshipping of the same. They are considered outside of the U.S. Customs territory.

My first personal involvement with free trade zones came during my study years in the free trade zone, or free port, of Budapest, Hungary. Later, mostly during the last 15 years, I visited and worked with many of the free ports and free trade zones in Africa, Panama, the Bahamas, and in Europe.

In recent years, the free trade zone movement has achieved new momentum. Since of World War II, many new facilities have been created, their geographic distribution has become more widespread, and their institutional forms became more varied to meet diverse local conditions. Many countries in Latin America, the Middle and Far East, and Africa have sought to employ the device as a tool of national economic development. Frequently, facilities in these areas take the form of a combination of free trade and free industrial zones. They are intended not only to improve the possibilities for the use of national ports, but also to facilitate the development of national export industries.

The fundamental purpose of the customs-privileged facilities is to facilitate the exchange, transfer and movement of industrial use of goods among nations having different international trade restrictions. They tend to be situated, therefore, in or near important commercial centers on world trade routes where goods can be easily received, dispatched and distributed internationallly. The majority are located in seaports, but some can be found at airports, border stations and, lately, in inland industrial parks.

In general, any goods from any country with which the host country has normal trade relations can be accepted. Domestic goods and duty-paid foreign goods brought into a foreign trade zone are considered exports from the customs territory of the host country unless special steps are taken to retain their nationality. Upon introduction into a foreign trade zone, such goods can become eligible for any applicable export incentive, tax refund or draw-back payment.

"The use of foreign trade zones for exports is often overlooked," said John Daponte, Jr., Executive Secretary of the Foreign Trade Zones Board. The estimate that only one of 12 domestic manufacturers is involved in exporting its products, while it could well be one of six, indicates a great potential for improving our national balance of payments in trade.

For this reason, it is a most appropriate time to focus on the ways in which the special customs procedures available in foreign trade zones can assist firms exporting from the United States.

Any foreign goods or materials brought into a zone for any permissible activity and ultimately shipped to a third country, either in their original or a completely altered condition, are not subject to customs duties or Federal excise taxes, and usually are not chargeable against quotas. This makes a zone a suitable place for export manufacturing operations.

Zone exports involve a means of obtaining export status on domestic goods prior to their actual shipment overseas. This benefit applies in situations where some kind of government credit accrues upon exportation. This accelerated export status can also be used in applying for Federal excise tax rebates on exported goods. It fits exactly into the concept of the present proposal.

On February 27 and 28, 1984, I attended the National Foreign Trade Zones Association's Board of Directors meeting as the chairman of the association's educational committee. We discussed at that time, Mr. Chairman, your proposal, namely the International Trade Tax Act of 1984. The directors of the board passed a resolution giving full support to your proposals. The board members, all individually directors and managers of foreign trade zones around the United States, understand the potential of the proposed act.

To be of substantial use to an international trader, a foreign trade zone should meet three basic qualifications: one, it should be well located; second, it should be well equipped; and third, it should be well administered.

Utilization of foreign trade zones for American international companies is not only an excellent idea, but could be the missing link for the small "exporters-to-be" businesses. Foreign trade zones could provide not only legal accommodation, which is acceptable by GATT members, but also important and crucial expert help to enable small businesses to compete in the international market and, through their efforts, assist our great Nation's economy dramatically.

Thank you.

[Mr. Keitner's prepared statement follows:]

PREPARED STATEMENT OF GEORGE K. KEITNER, PRESIDENT, GEORGE K. KEITNER & ASSOCIATES, INC.

My name is George K. Keitner, I am the vice president of the Buffalo Foreign Trade Zone Operators, Inc., and executive director of Foreign Trade Zone No. 23 in Buffalo, New York and Subzone No. 23–A in Webster, New York for Xerox Corporation. I am also the president of George K. Keitner and Associates, Inc., customs and free trade zones consultant firm. Previously I taught at Niagara University, Niagara Falls, New York and at Niagara College in Welland, Ontario, Canada. I wrote and published, through Niagara University, four textbooks on the subjects I taught, including international freight forwarding, United States Customs regulations and free (foreign) trade zones. I earned my education and diploma in Budapest, Hungary. I left Hungary after the Hungarian Revolution in 1956.

I am not a tax-expert; but I have over forty years of experience in the field of international transportation and commerce, customs procedures and in the field of free ports and free trade zones. I am honored to be invited to testify before this committee.

According to the Small Business Administration estimation over 30,000 small manufacturers are capable exporting their products. They are capable, but they are not doing it. Why? Basically, because they do not know how to do it. The export

procedures are complex, the regulatory requirements are lengthy and so, simply stated, they are afraid to export their products.

The small business community is concerned about the excess paperwork requirements, the complicated regulations, lack of expertise and naturally the unknown and mostly overestimated expenses involved in exportation. The export licensing requirements are a "mystery" for them. When they found out that a product requires a license to export, it is a deterrent for those who are unfamiliar with exporting regulations.

Although small business does not play a large role in the United States export market, it has the potential to add billions of dollars of revenue and millions of jobs to our Nation's economy.

At the General Agreement on Tariffs and Trade (GATT) Council October 1982 meeting, the United States trade representative, William Brock, announced that the administration would propose an alternative to the current Domestic International Sales Corporation (DISC) tax incentives, because of complaints made by the members of the council that DISC violates the General Agreements on Tariffs and Trade (GATT). This alternative must be "legal" from the GATT Council viewpoint and have to be usable for small businesses. This alternative should be the International Trade Tax Act of 1984, which was presented in the House of Representatives on February 2, 1984.

Among other provisions, the International Trade Tax Act of 1984 would merely require a small firm to set up a small American International Trade Corporation (AITC) which is created or organized under the laws of a foreign country. As an alternative, the small AITC could be created or organized in any foreign trade zone. This alternative would alleviate the psychological and financial burden on the small business of incorporating overseas. Further, small firms would have the option of participating on a joint basis—or in a joint trading company venture—as shareholders in an American International Trade Corporation.

In the United States, the terms "foreign trade zone" is used to designate the free trade zones facilities operating in this country. (The word "free" in connection with "port" or "zone" is apt to be misleading. It is proper to note, therefore, that the term has no relation to either port charges or to any policy of "free trade" or "protection" in this case. Conventional nomenclature in this case is misleading. A "neutral" zone would be more properly descriptive.)

One of the simplest and most effective explanations has been offered by Congressman Emanuel Celler who, perhaps more than anyone else, has been responsible for the initial foreign trade zone legislation in the United States: "A trade zone is a neutral, stockaded area where a shipper can put down his load, catch his breath, and decide what to do next."

By definition of the United States Department of Commerce, it is an isolated, enclosed (fenced), policed area under the supervision of the designated agency (Customs), operated as a public utility by a corporation, either public or private. It is in, or adjacent to, a port of entry, without a resident population, furnished with necessary facilities for loading and unloading, for the storage of goods and for reshipping of the same. They are considered outside of United States customs territory for purposes of customs entry procedures.

In the modern maritime nations the business of assembling and preparing the products of foreign countries for transshipment and redistribution abroad has grown steadily in volume and importance. The question now arises—where is the new business destined for a free zone to go, and in what way will it profit the country? The business proper to a free zone consists, in some extent, in receiving and manipulating foreign products and reshipping them in the direction and at the time to take advantage of the best foreign market. This is not only a profitable business, it is also a necessary business to our industrial growth.

My first personal involvement with free zones came during my study years, in the free trade zone (free port) of Budapest, Hungary. Later, mostly during the last fifteen years, I visited and worked with many of the free ports and free trade zones in Africa (Accra, Ghana), Colon and Panama City, Panama, Freeport, Bahamas and in Europe (Hamburg, W. Germany; Stockholm, Sweden; Copenhagen, Denmark; and Trieste, Italy); etc.

ORIGIN OF FACILITIES

Customs-privileged facilities are believed to have their origin in the ancient Mediterranean area. They are known to have been operative during the Middle Ages in the form of free cities, which permitted the free transit of goods. The Hanseatic League which contributed substantially to the stimulation of trade and economic de-

velopment in Germany was originally a confederation of trading towns, whose purpose was the reduction of obstacles of trade. Some modern free trade zones, Hamburg for example, trace their origin to these medieval towns.

As European trade with the Middle and Far East developed after the fifteenth century, a number of port cities in the Mediterranean area extended customs privileges to traders. More facilities were developed in the eighteenth and nineteenth centuries when European Colonial powers frequently established free ports in their overseas possessions, and non-colonial states created customs-privileged enclaves in their home ports to attract trade from their more prosperous neighbors.

In Europe a substantial wave of activity took place after the unification of Germany. During this period central governments generally tended to increase in strength and extend their control over subordinate local governmental bodies, and industrialized countries generally tended to adopt protectionist customs tariffs. Additionally, the opening of the Kiel Canal and the later defeat of Germany in World War I presented new possibilities for the handling of transshipment cargoes in the Baltic and Scandinavian areas.

These developments had two effects on free port activities. On the one hand, the device took its modern form, that of the "free trade zone" in which freedom from customs duties and similar controls is restricted to a delimited area. The free trade zone became the prevalent form of customs-privileged area in Europe. On the other hand, a number of new customs-privileged facilities were established in Germany and in the Scandinavian countries. The new facilities were usually called "free ports."

RECENT DEVELOPMENTS

In recent years, the free trade zone movement has achieved new momentum. Since the end of World War II, many new facilities have been created, their geographic distribution has become more widespread and their institutional forms became more varied to meet diverse local conditions. Many countries in Latin America, the Middle and Far East and Africa have sought to employ the device as a tool of national economic development. Frequently, facilities in these areas take the form of a combination of free trade and free industrial zones; they are intended not only to improve the possibilities for the use of national ports but also to facilitate the development of national export industries sometimes utilizing foreign materials.

Many major trading countries which do not employ free trade zones have developed other satisfactory systems for the purpose. These include special temporary entry provisions, bonded warehousing facilities and customs drawbacks as duty refunds on exports.

The fundamental purpose of the customs-privileged facilities is to facilitate the exchange, transfer, and movement of industrial use of goods among nations having different international trade restrictions. They tend to be situated therefore, in or near important commercial centers on world trade routes where goods can be easily received, dispatched and distributed internationally. The majority are located in seaports, but some can be found at airports, border stations and lately in inland industrial parks.

FEDERAL REPUBLIC OF GERMANY

The Federal Republic's free trade zones, which in German are called "Freihafen," have long been established. Of all modern free trade zones, the Hamburg zone's management, character and successful operation furnishes the best illustration to observe.

Hamburg spans both sides of the Elbe River at a point approximately 75 miles from the North Sea and about 56 miles upstream from Cuxhaven. It is the largest port in the Federal Republic and the easternmost port serving the North Sea and Atlantic shipping routes. Every 25 minutes a ship docks in Hamburg. Two hundred and fifty-five (255) liner services offer over 9,000 scheduled sailings a year from Hamburg. In addition to activities related to trade and shipping, Hamburg is an important financial and industrial center.

Goods of foreign origin may be brought into the free trade zone without payment of customs duties or becoming subject to the usual customs formalities. They remain free of duties while held in the zone or when subsequently transshipped or reexported abroad. Customs duties become payable, however, if the goods are removed from the zone for consumption in Germany. Similar treatment is accorded with respect to the import turnover tax (einfuhrumsatzsteuer). Goods of German origin brought into the free trade zone are considered exports and receive corresponding tax treatment. The administration of the Hamburg zone is empowered to approve manufac-

turing, assembly and other processing operations, whether or not using imported materials. The chief criterion for such operations is that its end-products be intended primarily, although not necessarily exclusively, for reexport.

The Federal Republic of Germany has six free trade zones. They are located at: Bremen, Bremenhaven, Cuxhave, Emden, Kiel and Hamburg.

SWEDEN

Sweden is one of the world's northernmost countries, and in terms of size, the third largest country in Europe. Although Sweden has numerous ports, international trade is carried out primarily through the three major maritime ports of Gothenburg, Malmo, and Stockholm. The national free trade zone law (Frihamnsstadga), enacted in 1935, established uniform regulations for all three free trade zones in Sweden, located in the above-mentioned three ports.

Stockholm, situated on the east coast of Sweden at the junction of Lake Malar and the Baltic Sea, is the country's leading Baltic port. Goods of foreign origin may be brought into the free trade zone without payment of Swedish customs duties or taxes and remain free of such duties and taxes while held within the zone or if subsequently transshipped or reexported.

Goods of Swedish origin and duty-paid foreign goods may also be brought into the free trade zone. Upon entry they are considered exports and become eligible for export rebates or drawback payments.

Goods held in the free trade zone may be used as collateral or sold. The zone's administering authorities are empowered to issue negotiable instruments indicating title to goods held on its premises, and thereby make possible their sale or mortgage through documentary transfers. Direct sales of customs-privileged goods to ships or aircrafts require special permission.

Sweden is one of the leading maritime nations of Western Europe, and numerous Swedish and foreign flag shipping companies provide frequent services between the ports and other countries. International air transportation is handled primarily at the Stockholm International Airport.

DENMARK

The Kingdom of Denmark is made up of three distinct geographic areas, namely, Denmark, the Faroe Island and Greenland. Long an agricultural country, Denmark has become highly industrialized in the years since World War II. Its chief industries are manufacture of machinery and electrical equipment, textiles and clothing, chemicals, food processing and shipbuilding. The country, however, lacks many raw materials and is dependent upon imports to sustain its industry. Owing to its insular character, Denmark relies heavily on water transportation for domestic distribution as well as international trade.

Copenhagen the capital of Denmark is the principal population center, industrial hub and maritime port of Denmark. It is also the location of Denmark's free trade zone. It is situated on the eastern coast of the Island of Zealand, opposite the Swedish mainland. It faces on the Oresund near the main entrance to the Baltic Sea. This location affords it access to major shipping routes serving northern and Central European markets.

Goods of foreign origin may be brought into the free trade zone without payment of customs duties or other import taxes. Goods remain free of Danish duties while held in the zone, or subsequently reexported.

Authorized operations include storage, sampling, sorting, mixing, marking, repacking, processing, exhibiting and manufacturing. No contribution or taxes are paid either on the value of the goods held in the zone or on the profits made on the sale and purchase of goods when handled for foreign account.

The establishment within the zone of manufacturing or other processing operations of an industrial character requires the prior permission of the Ministry of Public Works.

ITALY

Italy has two free trade zones located at Trieste and Venice. More limited customs-privileged facilities have been established in other major ports and cities having customs inspection offices. Each of the Italian free trade zones has been established by special legislation. The provisions of the laws do not, however, differ significantly. All zones are supervised nationally by the Ministero Delle Finanze.

The free trade zone at Trieste is located in northeastern Italy, near the Italian-Yugoslav border. It faces on the Gulf of Trieste, an inlet at the head of the Adriatic

Sea. Trieste has a long tradition as a customs-privileged port. The entire city had free port status prior to 1866 when the free trade zone system was adopted. The legal basis for their operation is decree No. 29 of January 19, 1955.

Goods of foreign origin may be brought into the free trade zone without payment of Italian customs duties and remain free of all such duties while held in the zone or if subsequently transshipped or reexported. Goods of Italian origin or nationalized goods, i.e., goods of foreign origin on which Italian customs duties have been paid may also be brought into the free trade zone. Upon introduction, such goods are considered exports unless action is taken to maintain their Italian nationality.

The traditional economic activities of shipping, freight forwarding, banking and insurance continue, and there has been some industrial development in recent years. The port is served by numerous Italian and foreign-flag ocean carriers which offer more than 1,500 sailings annually. Formerly the principal port and commercial center of the Austro-Hungarian Empire, Trieste was transferred from Austrian to Italian jurisdiction at the end of the First World War, but still handles traffic to or from Austria, Czechoslovakia and Hungry.

PANAMA

The free trade zone is located in Colon, which is situated at the Caribbean entrance to the Panama Canal. It was created by Decree Law No. 18 of 1948. The actual operation began in 1953.

Goods of any origin, including machinery and raw materials, may enter the free trade zone without payment of customs duties or taxes of any kind, including consular fees.

The administration of the free trade zone handles operations connected with the distribution of goods, e.g., storing, assembling, labeling, freight forwarding, and other services, for firms wishing to use the zone without setting up their own establishments within the zone. In addition, several management companies furnish these services to firms using the zone. Wholesale firms operating in the zone may have sales showrooms in which representative stock may be displayed.

With the exception of income and social security taxes, commercial operations carried on in the free trade zone are exempt from national, municipal, or local community taxes, fees, or dues. Firms in the zone engaged in reexporting goods to another country are exempt from 90% of the regular Panamanian income tax with respect to income derived from sales of merchandise reexported from the free trade zone to countries other than Panama.

There are no Panamanian taxes on invested capital, dividends or remittances abroad, nor is there any tax on capital gains when the property or securities sold have been owned over two years.

Because of its strategic position at the junction of major shipping and air routes, the Colon free trade zone functions primarily as a transfer point, warehousing, manufacturing and regional sales center.

Now giving some examples of the activities of free trade zones in Europe and in Panama, I will continue my testimony on the present situation in the United States' foreign trade zones.

FOREIGN TRADE ZONE CHARACTERISTICS

A foreign trade zone, (free trade zone), is "free" only with respect to customs duties, import taxes, and possible other import controls normally imposed by customs laws and regulations.

Bond or other security is not normally required. In general, any goods from any country with which the host country has normal trade relations can be accepted. Domestic goods and duty-paid foreign goods brought into a foreign trade zone are considered exports from the customs territory of the host country unless special steps are taken to retain their nationality. Upon introduction into a foreign trade zone such goods can become eligible for any applicable export incentive, tax refund or drawback payment. There is generally no limit on the length of time during which goods can be held in a foreign trade zone.

Goods held in a foreign trade zone can usually be sold at the wholesale level through auction or other means. Title to such goods can be transferred; also, such goods can be used as collateral for loans. Arrangements can usually be made to use a foreign trade zone for freight forwarding purposes. The service may be provided either by the administering authority of such a zone or by local firms operating within. In some cases, local firms offer agency-type arrangements under which they will act in behalf of a foreign company to undertake any authorized operation.

"The use of foreign trade zones for exports is often overlooked." (John J. Daponte, Jr. executive secretary, Foreign Trade Zones Board). The estimate that only one of twelve domestic manufacturers is involved in exporting its products, while it could well be one of six, indicates a great potential for improving our national balance of payments in trade.

For this reason it is a most appropriate time to focus on the ways in which the special customs procedures available in foreign trade zones can assist firms exporting from the United States.

Foreign trade zone exports fall into the following categories:

(1) Foreign goods transshipped through U.S. zones to third countries;

(2) Foreign goods processed in zones then transshipped abroad;

(3) Foreign goods processed or assembled in U.S. zones with some domestic materials and parts and then reexported;

(4) Goods produced in zones wholly of foreign content and exported;

(5) Goods produced in zones from a combination of domestic and foreign materials and components, then exported;

(6) Domestic goods moved into a zone to achieve export status prior to their actual exportation.

The advantages zones provided in the first five situations are basic to the zone concept. Any foreign goods or materials brought into a zone for any permissible activity and ultimately shipped to a third country, either in their original or a completely altered condition, are not subject to customs duties or Federal excise taxes, and usually are not chargeable against quotas. This makes a zone a suitable place for export manufacturing operations in which high duty foreign components and materials are needed to make the end product competitive in overseas market.

The fifth and sixth types of zone exports involve a means of obtaining "export status" on domestic goods prior to their actual shipment overseas. This benefit applies in situations where some kind of Government credit accrues upon exportation. This "accelerated export status" can also be used in applying for Federal excise tax rebates on exported goods. It fits exactly into the concept of the present proposal.

On February 27th and 28th, 1984, I attended the National Foreign Trade Zones Association's Board director meeting as the chairman of the Association's Educational Committee. We discussed at that time, Mr. Chairman, your proposal, namely the International Trade Tax Act of 1984. The directors of the board passed a resolution giving full support to your proposals. The board members, all individually directors and managers of foreign trade zones around the United States understand the potential of the proposed act.

To be of substantial use to an international trader, a foreign trade zone should meet three basic qualifications.

(1) It should be well located;

(2) It should be well equipped; and

(3) It should be well-administered.

Utilization of foreign trade zones for American international companies is not only an excellent idea, but could be the "the missing link."

For the small "exporters-to-be businesses," foreign trade zones could provide not only legal accommodation (which is acceptable by GATT members) but also important and crucial expert help to enable small businesses to compete in the international market and through their efforts assist our great Nation's economy dramatically.

Mr. NOWAK. Thank you very much.

Let me ask a couple of questions. What type of export activities are now carried on in foreign trade zones?

Mr. KEITNER. Your question is naturally, what kind of export activities are carried on in the United States foreign trade zones? I will start maybe from my experience where I am involved.

We are on the Canadian border in Buffalo, and that is our starting point. Canada has no foreign trade zone. The reason is the British North American Act does not recognize such an establishment. They have bonded warehouses, clean warehouses, et cetera.

For that reason, many of the zone users in the Buffalo area are Canadian companies who are importing mechandise, sometimes from overseas—United Kingdom, Australia, and other parts of the world—and they are transferring over to our zone, which will be

reexported from there in many cases. It could be from peanuts arriving from China or South Africa, to bathing suits from Italy which are somehow changed in the foreign trade zone under the existing regulation, they are machine parts which arrive from the United Kingdom and was equipped up to the North American standard requirement to be exported again. It is a long list. But, basically, to export from the zone of Buffalo is directed to Canada and directed to South America.

Now, lately, we started a subzone, which is for Xerox Corp. in Rochester. That subzone was established basically for export purposes. Xerox was in a situation that, if there was not a solution found for their situation, they have to close down the whole plant and become only a subsidiary of Fuji-Xerox from Japan, bringing the copy machine—which is one of the products—into Rochester and then sell it to the market or exported. Through the zone situation, they were able to not only keep their plant going, which meant about over 10,000 jobs, but they are able to produce more for export. In the first year, they are raising the export situation over 10 percent.

That is my answer to your question, Mr. Chairman.

Mr. NOWAK. I wonder if the AITC was adopted, would you visualize broader participation by small businesses? You allude to expanded opportunities in your testimony. I wonder specifically if you would quantify different opportunities for small business if they became familiar with all of the intricacies of the foreign trade zone, if they were allowed to operate out of the foreign trade zone?

Mr. KEITNER. My answer is definitely yes.

I base my answer on the following experience. During the last 8 years, we were running this foreign trade zone in the Buffalo area, I visited many places in Europe, and these companies were interested in bringing over the whole manufacturing concept to the United States looking for the right area. Our site is the right area for them because they are able to serve Canada and the United States from one location.

Lately, I am not traveling as much overseas, but I am over weekly in Canada. The Canadians are interested in doing some work which is for their purpose export oriented, and that would be one item which I can foresee that the foreign trade zone could accommodate.

Naturally, since I am aware of your tax proposal, I was talking about in the foreign trade zones national association with people individually and talking with many, many colleagues and present manufacturers who are not exporting. And when I am talking about that proposal and explain to them what could be done in a foreign trade zone, starting to establish an office, a showroom, and organize their export procedure under expert advice at the present in the foreign trade zone, they are very interested.

I would go back from here and talk to them, naturally continuously, and telling them more what we can do for them. I can visualize—maybe I am overly optimistic or I am maybe much more involved in the foreign trade zone concept in my whole life and I can say: "I am in love with foreign trade zones." I can see to build in a foreign trade zone a 20-story-high building which will accommodate only those kinds of companies which are conducting their business

from the foreign trade zone under this proposed act legally, which has to be accepted by any other nations because they are doing the same. Why should we always come after those people and fight against it when we can be the leaders? If it is legal for those countries—I mentioned in my testimony which I submitted to the committee—I mentioned only some of them—but many others are doing it and getting tax incentives, being located in a free port and doing the exportation without any kind of protest from other countries. But we are the good guys who are not doing it.

Mr. NOWAK. Yes, Mr. Chancler.

Mr. CHANCLER. Mr. Chairman, I would have to think that if small companies did locate under your proposal in the foreign trade zone, and where they are daily involved in a trade environment, a few lights would go on, and also that this would be contagious perhaps to other companies that are not now involved in a DISC or the export-related activities.

Mr. CRESKOFF. I would like to also mention that today the major utilization of foreign trade zones is manufacturing operations, which is something that we haven't discussed. These are conducted in so-called subzones, manufacturing subzones, and offer, I think, enormous opportunities for small businesses. Right now, I think that that automobile industry is the primary user of this procedure and of foreign trade subzones.

But I think that, as small business comes into contact with foreign trade zones and what can be done in foreign trade zones, I think there will be enormous applications.

Mr. NOWAK. Let me just conclude here. Your organization, which has, I assume, the majority of the 97 foreign trade zones—are all 97 members of the organization?

Mr. CHANCLER. Not all 97 are, because some of them have just been—they have been approving zones, let's say, within the past 60 days, but they have been solicited for membership. I would say that, of the 97, I am going to give you an approximation of about 80 are members of our association.

Mr. NOWAK. I, too, agree with the general thrust of your testimony, that there could be many offshoots of this if the familiarity was there. Time and time again, we hear on the committee from small business that they have products, they have been successful here in the United States, and they can see the markets over there. However, because of the costs and time, and they looked at DISC and the changes that are coming in, see it is complex, and just, at this point in time, walk away from it.

I think we are missing just tremendous opportunities to move some products overseas and try to offset this trade deficit that has been growing to such extents that I wonder where we are going to find the balance. If the dollar remains strong to "fight inflation" somewhere down the line here in the not too distant future, we are really going to have some problems unless we can expand. As has been stated before, the large corporations are handling, I am sure, all the exports they can possibly throw out there, but we have missed opportunities from the middle- and smaller-size community that need to familiarize themselves with the export markets.

Your members in your association really, I think, could play a large role in bringing more people to the zones to get them inter-

ested and processed through the regulations and could start to make real impacts in this whole problem area.

I don't know when the dollar will lose some of its strength. That alone, I am sure, will have a good effect. But I think we wish the administration would look at this in little broader terms than just narrowly making the GATT legal and walking away from it. I do think that they are going to have greater problems if they run through this very quickly and get the incentive that they are considering in the Senate without looking at the other broader areas, and especially what your membership could do. I think the opportunities are there.

I would only ask—you have a broad membership to contact, and they, in turn, can contact members—my colleagues, and more specifically some of the members on the Ways and Means. No matter what we try to do with this, it is a complicated area. If you could generate the interest in your membership to start to contact those people and explain the potential that you have described here and in your testimony, I think it would help us greatly as we try to persuade the Ways and Means members to make some adjustments.

I think we have a terrific opportunity to do that. We tried to fashion it to bring an impact that is really much broader than just making this "GATT legal." I think we have the substantive way to have much broader impacts than any of us are even visualizing right now, although as you know, they are worried about lost revenue.

But I just foresee that unless we can fashion a quick fix for our export market very quickly, there are going to be bigger problems than just lost revenue. As we look down and see the kind of impacts that are starting to come out of this economy the way it is sitting now, and may sit for quite a long while before we can make any other adjustments, we need to take some kind of interim action.

So I would just urge that you could have as many people individually in your membership informed about this, and urge them to make that next step and contact their own people, because in an area that is a little complex, it is hard to move the individual members to join when they are contacted. I know Mr. Keitner has played a role in that already. I just hope that everybody can do it.

Again, thank you for your testimony. Again, we will keep the record open and try to fill in what we have to. Thank you very much.

Mr. NOWAK. We now have two witnesses to come to the table together, Donna Foster and Mr. Richard Levy. They are members of the industrial sector advisory committee for small and minority business of the U.S. Department of Commerce. They are representing their own views at this time and not testifying on behalf of the Department.

Donna Foster is the president of Foster Consultants in McLean, Va. She is a member of the board of directors of the chamber of commerce of Fairfax County, Va., and has been a member for 4 years of the chamber's committee on international trade. She was a chamber representative on the trade commission to Zurich in October 1983 to promote exports from Fairfax County. She has been the president of Foster Consultants for 10 years, a company that,

among other things, provides foreign language capabilities, such as translations and expertise in foreign trade.

Richard Levy is an attorney from Alexandria, Va. He has been heavily involved in the experimental program of the Department of Commerce to find foreign trade markets for lubricating oils and hydraulic fluids sold by small and minority businesses.

We welcome you both here.

Ms. Foster, if you would, we would like to hear your testimony.

TESTIMONY OF DONNA FOSTER, PRESIDENT, FOSTER CONSULTANTS

Ms. FOSTER. Mr. Chairman, I want to thank you for inviting us here today to bring you our views. You have our testimony and, in the interest of time, I think I will just summarize some of the points we would like to see in the bill, both clarified and maybe added to a little bit.

Mr. NOWAK. Your testimony in its totality will be entered in the record.

Ms. FOSTER. Thank you.

I think the two main things needed to increase exporting by small businesses are to keep the rules and regulations simple and to make sure it is profitable.

Along those two lines, simplicity is one of the most important, and I would like to relate an anecdote which will illustrate this point. A small businessman who reported to us told us that his DISC was set up by one of our Big Eight accounting firms. For some reason, after it had been in existence for a year or so, he changed accounting firms, and was informed by the second accounting firm that it had been set up totally incorrectly, and it was necessary that it be set up again, supposedly correctly. This cost him $30,000, and he still is not sure whether No. 1 was correct or No. 2 is correct.

Those kinds of complications and misunderstandings are very hard for the small businessman. So we would recommend that the rules and regulations be kept simple.

With respect to the Internal Revenue Service area, we would like to make sure that the foreign presence requirement is very specific so there is no opportunity later for them to declare that it wasn't done right causing the small businessman further suffering.

We would also like to suggest allowing the small exporter a flat, easily calculable tax exemption for the profits from exports, involving a very simple formula. Rather than having to have a complicated form of deciding what are profits from exports and what are profits from domestic sales, we would suggest they allocate the firms' profits between domestic and foreign sales in the same proportion as the firms gross revenues are divided. If you have 45 percent gross revenues of the firm from export sales, then the firm would assume that 45 percent of its profits before tax came from export, too.

We would also like to see the exporter choose the methods for affiliated pricing to allow whichever one suits their situation the best, so that it does not involve a complicated set of changing their books to accommodate a system that is acceptable by the IRS.

The other thing, of course, is to make it profitable; financing on reasonable terms is what the small businessmen are looking for. In this line, we would like to see the tax exempt income from the FSC calculated so that it could be shared with anyone else, which will make it more attractive to banks. If they could share the pass-through tax exempt income—as long as it is done for a legitimate reason—they and the person they are borrowing from can decide how much they are going to split, if they are going to split 50/50 or whatever. This would make loaning to small businesses for export more attractive to the banks.

I think, being realistic, we have to realize that it does cost the banks more to handle a small loan. For this reason, we would also like to see the minimum profit be moved to $10 million rather than the $5 million that the Senate has written into its bill now.

I think that basically covers the area that I am going to take care of. Mr. Levy will finish with a few more points that we have.

Mr. NOWAK. Fine. Mr. Levy.

TESTIMONY OF RICHARD LEVY, ATTORNEY

Mr. LEVY. Thank you, Mr. Chairman.

Just to elaborate on what Ms. Foster said concerning the participation of the IRS in implementing this bill to regulations, let me add the following.

You recall she said that the bill should be as specific as possible. If the administration's views and your views are accepted by the Congress, for example, on foreign presence requirements, the bill should be made as specific as possible so that the IRS, through its regulations, may not weaken the benefits that even the administration's bill wishes to confer on small business, by enhancing or elaborating on foreign presence requirements.

In addition to that, there are two other points. We should suggest that which ever bill is accepted by Congress, if final regulations are not promulgated in 4 months after the date of passage or effective date of the act, or are invalidated by a court, no small exporter should be subjected to unfavorable retroactive application of the regulations that are subsequently enacted and issued, if that small exporter has acted reasonably and in good faith until that time—until the effective issuance of the subsequent regulations.

Such reasonableness and good faith should be presumed, and the IRS should have the burden of disproving reasonableness and good faith.

This provision is important to make sure that another of IRS' practices does not impede small exporters under this bill—under this program. It has sometimes happened that where IRS does not like a statute, it will delay issuing regulations under it, sometimes for years. The businessman must then either delay taking action under the statute or take action at his peril.

If, after he takes action, the IRS subsequently adopts regulations that disqualify what he has done, and then IRS applies them retroactively, as it is wont to do, the businessman will lose a large part or all of the income that he thought he had earned exempt from tax. Few small exporters will risk, or can bear, such a peril of adverse retroactive application.

To meet this risk, the legislation should allow such businessmen tax benefits regardless of what IRS subsequently does if they acted reasonably and in good faith, after waiting 4 months, and before the regulations became final, or if the regulations are invalidated by a court.

Finally, the third point, to keep regulations from undercutting the value of the bill or the program, any small exporter should have standing to challenge the regulations that IRS issues concerning small exporters, and the court in such a suit, if brought by a small exporter, should treat the regulations of IRS on the points concerning the plaintiff, the small exporter, as interpretive regulations and not as substantive regulations.

As you know, courts may properly substitute their own judgment for interpretive regulations, but they may invalidate substantive regulations only if they are improperly promulgated procedurally, or if they are arbitrary and capricious, or if they are unconstitutional.

Thus, the first, more flexible standard for interpretive regulations should govern the regulations concerning small exporters so that the intent of the Congress, through the judgment of the court, will more reliably be carried out.

Finally, we should add that we believe that services should be as well included as goods under the bill. No good reason for not including them occurs to us or to anyone else we have spoken to. We, therefore, heartily recommend their inclusion, as, in fact, they have been included in your excellent bill, H.R. 4741, Mr. Congressman.

Thank you.

[Ms. Foster and Mr. Levy's joint prepared statement follows:]

JOINT PREPARED STATEMENT OF DONNA FOSTER, PRESIDENT, FOSTER CONSULTANTS, AND RICHARD LEVY, ATTORNEY

Allow us to submit the views on Tax Proposals To Foster Small Business Exports from several members of the Industry Sector Advisory Committee for Small and Minority Businesses. As we note below, these are only our views and not those of this Committee.

The Industry Sector Advisory Committee for Small and Minority Business, known as ISAC-14, is one of 17 committees of citizens established under section 135(c)(2) of the Trade Act of 1974, P.L. 93-618, to advise the Secretary of Commerce and the United States Trade Representative about the views, interests, opinions, and concerns of private industry concerning foreign trade. Most other ISAC's represent particular industries, such as leather goods or nonferrous metals. ISAC-14 represents all small and minority businesses, in whatever industry. Its thirty members from around the country serve without compensation and, indeed, even without reimbursement for the cost of travel to reach the meeting place.

ISAC-14 has been particularly active in the past two years of its present membership in the area of export promotion: it (i) has set out a description of the problems peculiar to small and minority businesses; (ii) has provided the Secretary of Commerce with a report on the acts and omissions of one of the district offices of the Small Business Administration in encouraging exports by small and minority businessmen; (iii) has provided the Secretary with a program of publicity and promotion to encourage small and minority businessmen to export; and (iv) is working with the Department of Commerce on an experimental program to use the Foreign Commercial Service at a reasonable fee to identify markets for products, lubricating oils and hydraulic fluids, that the Department does not usually monitor. Representatives of ISAC-14 are also active in bringing the views of small and minority businessmen to various offices of the government and to other advisory, policy, and legislative committees. Among such efforts have been those directed to presenting tax proposals of the ISAC's members to the Administration to foster small business exports.

We should like to tell you what we have been telling the Administration. Please note, however, that our Committee is not chartered to present its views to Congress. Its duty is limited to advising the Secretary of Commerce and the United States Trade Representative. Accordingly, the views presented below are those of the persons presenting this testimony. Although we are members of ISAC-14 and we believe they represent the views of the other members who have expressed an opinion on these proposals, this is not the official testimony of the Committee, but only our personal views. Descriptive information concerning us is attached.

The two guiding principles for our suggestions are simplicity in application and attractiveness to lenders—the first, in order that small and minority businessmen actually can use the proposals; the second, in order to help solve probably the most severe continuing problem of small and minority businessmen, obtaining financing on reasonable terms.

SIMPLICITY IN APPLICATION

Two anecdotes concerning Domestic International Sales Corporations (DISC's) will make our point concerning simplicity. A small businessman that we know reports that his DISC was established by one of the eight largest accounting firms. Subsequently, when he changed accounting firms for other reasons, he was told by the successor that his DISC had been set up incorrectly and had to be redone. Faced with this disagreement between two large accounting firms, he is at a loss to know which is correct—if either. Perhaps both are correct in part. The cost to him of originally establishing the DISC and then redoing it is $30,000, plus the continuing uncertainty whether his DISC is proper. Very few small or minority businessmen will be willing to spend that much money to purchase such uncertainty.

The second anecdote is the report from one of the persons in the Executive Branch that the Internal Revenue Service's audits of DISC's provided the largest return in deficiencies per man hour of any of the Service's audit programs. This is the price of the uncertainty the user of the DISC must pay—intensive audit, its accompanying expenditure of time and fees for attorneys and accountants, and subsequent assessment of deficiency. This will be a price that small and minority businessmen cannot afford. For them, provide a simple rule. We suggest this: allow small exporters a flat, easily calculable tax exemption for part of their profits from exports. For those exporters who sell domestically, as well as in foreign markets, allocate the firm's profits between domestic and foreign sales in the same proportion as the firm's gross revenues are divided. For example, if forty-five percent of the gross revenues of the firm come from export sales, then the firm may assume that forty-five perent of its profits before tax come from exports, too. Alternately, if it wishes, the small exporter may use generally accepted principles of cost accounting to calculate its profits from exports. Finally, the small exporter may choose the methods for inter-affiliated pricing allowed in your excellent bill, H.R. 4741. In other words, allow the exporters to choose any of these five methods, as best suits its circumstances.

Once the profit from the export sales is calculated, the flat percentage for exempt income can be applied. This percentage should be 34%. There are at least three reasons for this. The first is that this is the percentage that an exporter, under certain circumstances, may possibly attain under H.R. 4741. Second, small exporters need such an exemption because of the difficulties that exporting presents for them. In addition to all the other difficulties of being small, they must face, often with no additional staff, the extra tasks and risks of exporting and the disproportionally greater amount of paperwork. Third, an exemption of 34% is probably just the amount that the small exporter needs in order to obtain the financing he now cannot get or cannot get on reasonable terms. This last reason is discussed at greater length below.

We can expect several foreign countries to complain about any tax exemption for small exporters. While we do not take the foreign relations of the United States lightly, we believe that in this case the obvious answer is the best one. The effect is de minimis. Small exporters sell a tiny percentage of all of our exports. The increase in the share of small exporters that will follow from our suggestions will still be de minimis.

ATTRACTIVENESS TO LENDERS

As we have mentioned above, the most severe continuing problem faced by small and minority exporters is obtaining loans on reasonable terms or even obtaining them at all. The big banks are reluctant to make loans that are, from their point of view, small, and the small banks are fearful of lending where the customers are for-

eign. All banks cite the burden of paperwork and of loan administration as a serious additional problem for them.

The Small Business Administration is good friend but only a lender of last resort, and is limited only to a guarantee of up to one-half million dollars, inclusive of any other guarantees the business has from the Administration.

The Export-Import Bank is now trying to fulfill the mandate in its recent re-chartering, for which we owe you thanks, to extend the benefits of its program to small and minority businesses, but so far results have been few. Up to last month, the lastest we have heard, the Bank had processed no loan smaller than five millon dollars.

A serious problem with the programs of both the SBA and the Export-Import Bank is that they are primarily guarantors of loans by commercial banks. Even with these guarantors, commercial banks have been very reluctant to make loans to small exporters or to make them on reasonable terms. The reason appears to be the heavy burden of paperwork and cost of loan administration.

At present, therefore, the problem of financing continues unsolved for most of the small and minority exporters. Our suggestion we believe will go far toward solving this problem. Let the small exporter share its tax exempt income, calculated as above, with anyone else, so long as there is a valid business reason. Thus, in addition to interest on its loan, a lender to small exporters could receive a share of the tax-exempt income. This additional income, which would pay the relatively high costs of paperwork and loan administration, should be a sufficient inducement to bring lenders to service the small and minority supporters they are not now serving. At the same time, the cost to the exporter would be approximately no more than the interest on the loan. To take an oversimplified example:

If today the exporter made $200 on an export sale, then, assuming 46% tax rates, he would pay Federal income tax of $92, leaving him $108. Under the suggestion, however, the exporter would pay taxes on only $132, because $68 (34%) would be tax exempt. He would thus pay taxes of $61, leaving $139 ($200 minus $61). If he then paid 50% of the exempt $68, or $34, to the lender, he would have left $105, only slightly less than he would have today. But he would also have the additional benefit of making the sale he presumably would not otherwise have made without the loan, and this should more than make up for the regular interest that he also would pay.

Further, if the lender performed his service as an Export Trading Company under the Export Trading Company Act, 15 U.S.C. § 4001 et seq., it could probably receive insurance under programs of the Export-Import Bank for 90% of his loan or for the exporter's receivables (that would be assigned to him).

Thus all interested parties benefit: the exporter receives financing he cannot now get and makes additional sales and profits, the lender makes a profit at low risk, the locality where the exporter is located receives extra business, employment, and taxes, and the United States gets the additional exports it so badly needs. And these benefits are brought by the free market, spurred by a tax incentive, rather than by bureaucracy.

Observe the above example is justification for the 34% as the percentage of exempt income for small exporters. Half of the 34% exempt income will probably be the amount needed to attract the lender's capital in the face of heavy paper work and costs of loan administration. As the above example shows, the remaining half will keep the small exporters approximately where they are today but now with reasonable financing and increased sales. Thus the 34% for the small exporter is well warranted.

By an extension of the same reasoning, the definition of small exporter should be one whose exports amount to ten million dollars or less. (Profits on revenues above this amount would be treated as ordinary income.) A lower limit will provide the average exporter too little exempt income to interest lenders. Take a limit of $2,500,000. Assume the exporter makes 10% on sales. Ten percent of $2,500,000 is $250,000. Thirty-four percent of that is $85,000. One-half of this is $42,500. This cannot be considered a sufficient inducement for lenders who have shown great reluctance until now to make their funds available.

Yet by raising the amount to $10 million, you will still not have so large an effect that foreign members of GATT can reasonably complain.

In sum, we suggest as guiding principles for tax proposals to foster small business exports, simplicity in application and attractiveness to lenders. Follow these principles and you will free from entangling complexity and lack of capital the entrepreneurial spirit of American small and minority exporters.

We add one other point. There is no reason not to include in these proposals the export of services. The main argument for not doing so is this: The common rule of

international tax law is that the country where the service company performs its services may impose its taxes; the U.S. will give a credit under its taxes paid to the host. Whatever additional credit the U.S. may give will just be "soaked up" by the host country by an increase in its tax rate. But even assuming that all or most host countries would apply this "soak-up" tax, the point would not apply to those services rendered to foreigners in ways not taxable by the foreigners' governments. In these cases, the small exporter of services should have the same 34% tax exemption as the small exporter of goods.

Allow us, Congressman Nowak, to express our gratitude to you for the bill that you recently introduced, H.R. 4741. There, small exporters are allowed up to $10 million of exports and services are included. These provisions should be very helpful to small and minority businesses.

Mr. NOWAK. Let me ask a couple of questions.

First of all, how responsive have you found lenders to your idea of sharing the tax incentive with them?

Mr. LEVY. Mr. Chairman, I have been in pretty steady communication with a large regional bank in this area. I have been talking with the vice president in charge of the international division. He has come to this point—he says that if, in fact, the tax situation of his bank is favorable, he will be very interested in engaging in the program that your bill would allow him to do. He is not a tax expert himself. He has gone to the corporate tax people, and they have promised him an answer in 2 weeks.

At the very least, he will be mildly interested; at best, depending on their particular tax situation, they will be very interested.

He does say that, regardless of the situation of his particular bank, in general, of course, the program that your bill would allow would help all exporters get loans far beyond what they are able to do today. Each bank has to look at its own tax situation individually, but there will be many banks which will find such a program very attractive. Therefore, I have to say that, at the moment, it looks like—judging from this bank, which is a very conservative one—the interest is there.

Mr. NOWAK. Ms. Foster, in your related service industry—and I guess you could look at that from your own experience—what do you see—how important is the export of our services in this whole scheme, and what kind of effect could you see that have on our trade situation?

Ms. FOSTER. I think it is getting more important all the time. Our economy is turning out to be a service-oriented economy. I think the small businesses are looking to taking some of these abroad. In numbers, I wouldn't know what the percentage would be that could be generated this way, but I think that certainly the interest is there, and I think the way the whole economy is going, it is a growing field and an opportunity that they will pick up on as soon as we can make them aware of it.

Mr. NOWAK. Yes.

Ms. FOSTER. I think it is important, when we are bringing this bill up to date, that we do it all the way. As you mentioned earlier, I would like to second that, that the economy has changed so for small businesses. There was a day for a small businessman—this is my typical example—when a diaper service was a very good small business, and then technology and things brought along disposables, and that industry is practically out of business.

I think that we have to be aware of what is the incoming business. I think service is one of the incoming industries. We are

going to be losing off some on the other end that maybe could have been exporters earlier, but for lack of technology and other reasons, they are no longer interested in export—I mean, there is no market for them.

I know we are concerned about the tax benefit or tax loss—but if we can get small businesses to grow by exporting, we are going to benefit the Government with taxes from more people being employed, from corporations being in a higher bracket to pay taxes, the people who they buy from are also going to benefit, and the whole economy will grow.

Mr. NOWAK. The whole supply-side notion has been to reduce taxes and we are going to get a big benefit. We are talking about general income taxes.

But I think when you look at specific incentives as we are talking about here, the revenue so-called drop is really and truly going to be overwhelmed by any export increase that we have. If we could have put that whole incentive in exports, I think that very truly you would have seen tremendous increases in broad revenues for the Federal Government. But we cut taxes generally, and you didn't get the specific overwhelming increase in revenues that were predicted by some of the administration and other advocates of that system.

Yet, now we are back to the point where we can't do too much for the exporters of small business because you are going to lose revenue. So you get a narrow kind of look at this and, yet, I am sure if you would analyze the impacts of increased exporting and what little incentive this would be, you would truly be overwhelmed. But, of course, we didn't do that.

Ms. FOSTER. I think, too—I understand there is a lot of resistance to making services part of this, especially from our GATT partners. If it is to be included as a first step, a door opener just for the small businesses, that is still going to be minimum.

Mr. NOWAK. Yes; it is amazing how many people who were formerly with larger types of corporate entities, who have, because of consolidations of those industries, lost their position or have been recycled down and were unhappy and have gone out into consulting. I think it is probably one of the largest growing areas. There are now consultants to consult with consultants, and all are finding a niche.

I have talked to many people who have left large corporate marketing because there was no position for them within the corporation and marketing, but as soon as they removed themselves and started a consulting firm, were rehired as a consultant to the corporation to perform servicing. It is happening, I think, in a greater and greater dimension. More people are recycled out, at middle incomes and higher levels, and start their own businesses very quickly.

I think that many of those kinds of services they are performing here, especially as we have increased trading and the servicing of not only the goods that are brought in here but, hopefully, the goods that will be sold overseas, more consulting and communication will have to come into being if we are going to keep up that kind of open trade and dialog.

Let me ask one more question, Mr. Levy. I wonder if you could run though the interpretive regulations that you were talking about, how that specifically could be affected if the Senate bill is passed without any changes or without any explanation, even in the legislative history?

Mr. LEVY. I guess I would put language into the bill, if possible, but surely in the legislative history, to the effect that any suit brought by a small exporter challenging a regulation or rule issued by the IRS shall be treated as if—let me go back.

I can't draft legislation as quickly as I should be able. I guess I would do it the other way:

Any regulation involved in a suit brought by a small exporter should be treated by the court as an interpretive and not a substantive regulation. That would be the language in the legislation. The committee report or the conference report would go on to say why that is: Let the court substitute its judgment for the judgment of the IRS.

It isn't that I am opposed to the IRS as such; it is just that the history of IRS is that, whenever there is a tax benefit granted by Congress for a certain aim, to lean against it in the regulations under that benefit. If they issue those regulations according to notice and comment under 5 U.S.C. 553, the courts cannot invalidate those regulations no matter how strongly they disagree with them unless the regulations are issued improperly procedurally, or they are arbitrary on their face or as applied, or unconstitutional. So the IRS almost always wins the suits. I think maybe every year only two or three regulations are overturned.

This way the court can say, "I disagree with that interpretation of the statute, Congress did not intend that, this is what the Congress meant." That would make much more sure that your intent will be carried forward.

Mr. NOWAK. Is there a precedent for putting that language into a specific bill?

Mr. LEVY. I am afraid I can't think of any, Mr. Chairman.

Mr. NOWAK. I am trying to agree with the general thrust of what you are doing. I am wondering how we can make that interpretive regulation.

The other point is well taken about the length of time that these regulations will take to be published. That, in itself, could discourage an awful lot of people to even look at this, once they go to tax counsel and find out they are in jeopardy, whether or not they go ahead or don't go ahead. I think that would have to be specifically put in, too. I have alluded to that several times. I think it is an area that, when we look at the Tax Code and we see the changes that have been made retroactively and read some of the decisions that have come out of the courts upholding retroactive effect, and in relatively narrow areas, you can see great problems with this if it is challenged somewhere down the line. If someone goes in and is retroactively found illegal in this whole situation, it could have tremendous monetary effects, not only in setting up the corporation itself, and their whole cash flow or their business could be destroyed.

Mr. LEVY. It would make it very difficult for any bank already leery of lending to small exporters to lend if banks could not be told definitely what the benefit would be to it.

Mr. NOWAK. I hope that you will both work with the counsel of this committee to see if we can devise specific language to cover all of these. Of course, we will try to urge our own Ways and Means members to be aware of this problem. That is a job in itself as we get into the larger areas that they are looking at.

But I think if they miss the significance of this, it could really hurt our whole export business for years and years to come, and just keep reducing it. If we see the deficit expand, everybody will sit and wonder why we are not exporting.

We appreciate your time and the testimony that you have submitted. We will have that as part of the record. We will certainly try to get a broader influence, and look forward to working with you and, in fact, the Senate committee, as they move forward with this incentive. Thank you again for appearing.

Mr. LEVY. Thank you.

Ms. FOSTER. Thank you for having us.

Mr. NOWAK. Our next witness is from the Smaller Business Association of New England, Inc., Thomas Schinkel, who is the president of two businesses, Thomas Schinkel & Associates of Lexington, Mass. and the Boston Venture Fund.

The Venture Fund has the objective of investing in companies with export potential. Prior to starting his own firm 7 years ago, he was active as an international marketing consultant for several consulting firms.

I want to welcome you before the committee, Mr. Schinkel, and let you know that your testimony also, which is very comprehensive and complete, is made a part of the record, and we will go forward from that point.

TESTIMONY OF THOMAS SCHINKEL, PRESIDENT, THOMAS SCHINKEL & ASSOCIATES, ON BEHALF OF THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

Mr. SCHINKEL. Mr. Nowak, members of the subcommittee, and audience, thank you for inviting me. My name is Thomas Schinkel, president of Thomas Schinkel & Associates and the Boston Venture Fund, both of Lexington, Mass. Both are actively engaged in export assistance to smaller, high-technology manufacturers and service companies in New England.

I appear before you as a member of the board of directors of the Smaller Business Association of New England, SBANE, which is headquartered in Waltham, Mass. SBANE is a member of Small Business United, the Nation's coalition of small business organizations.

SBANE has frequently testified before various House and Senate committees on the subject of DISC and FSC legislation and, therefore, I would like to make this statement as brief as possible.

Mr. Chairman, SBANE feels there has been a barrage of Government actions in the recent past all focusing on efforts to strengthen the U.S. export position in general, and small business exports in particular. Examples, of course, include the SBA export loan pro-

grams—the set-aside programs—the Export Trading Companies Act of 1982, efforts of the Eximbank to reach out to small business, and the private Overseas Investment Corp.

Yet, there are strong forces at work causing small business to lose ground in overseas markets which had been gained during the late 1970's. Much of this is caused, we believe, by the absence of a monetary policy to keep the dollar exchange rate within reasonable parameters against other currencies. Many small exporters have lost up to 50 percent and more of their export gains, and this has happened in a time span of less than 24 months.

Supply-side economics, as practiced by the Office of Management and Budget and the Treasury Department, dictate the slashing of Government budgets for direct export promotion at a time when this sort of stimulus is needed more than ever.

Mr. Chairman, we are witnessing, in the view of SBANE, Government policies which seem to contradict each other and which tend to neutralize and eventually minimize all efforts by the Government and the private sector to build a strong economy based on substantial exports overseas.

SBANE is generally in favor of a comprehensive and coherent long-term international trade policy which takes advantage of every legal opportunity to stimulate and facilitate exports by small companies. Small businesses are often amongst the most innovative companies making a strong and meaningful contribution to the well-being of this country through job creation and earnings from exports.

Within the context of such an overall long-range set of goals and objectives, SBANE recognizes legislation to replace the present DISC rules as an important part of the Government's toolbox for export promotion.

However, for small business to take advantage of this and other incentives for exports, it would almost be mandatory to look for programs that are simple to understand and whose administrative requirements are kept within reasonable boundaries of cost effectiveness.

A sentiment which is often heard in the small business community with respect to both DISC and the proposed FSC rules is that these programs provide just another bonanza for the big eight accounting firms and for the legal profession.

As soon as small business executives feel that they are left at the mercy of such institutions, they tend to withdraw their active interest.

It is against this background that SBANE strongly favors most or all of the pertinent aspects of H.R. 4741. Specifically, SBANE would like to express its support for:

One, the bill's definition of an AITC. The $10 million average foreign receipts is an adequate level.

Two, the foreign trade zone feature presents exactly the kind of alternative small business has been looking for. This opens a choice between various understandable alternatives and it avoids monopolization of FSC implementation by accountants and lawyers.

Three, the bill's broad definition of the performance of services has SBANE's strongest possible support. Mr. Chairman, during the 10 to 12 years since DISC was passed, the American economy has

undergone fundamental change. The predominant contributor to this country's gross national product is the services sector. It is widely known that the recent decline in unemployment has come from new business formation. The majority of these businesses are service companies.

For a legislature to stick to formulas and definitions of the past is like recounting yesteryear's harvest while the season for sowing new crops is upon us.

The argument sometimes heard that the inclusion of services is nonrevenue neutral is outright shortsighted.

The net present value to this country of additional export dollars generated in the service sector over a period of 5 years is a multitude of the dollars saved in a short-term attempt to balance a budget.

Four, additional elements in Representative Nowak's bill that have SBANE's support include the promotion of AITC joint ventures—that feature is very important to us—the exemption of accumulated DISC income from tax; and the grace period provision for treatment of transfers from DISC to AITC.

Allow me to make one final comment on the argument that some of the small business provisions may or may not be acceptable under GATT rules.

SBANE feels that U.S. negotiators should be given a mandate to make a more aggressive stance on this international platform to defend small business interests.

As long as European governments can offer their small business outright cash grants for overseas market surveys and incentive export loans, the repayment of which is waived if and when certain export goals are met by the borrowing small or medium size company, SBANE feels that a more aggressive posture by U.S. negotiators is warranted.

Thank you for the opportunity to present SBANE's views before your committee.

[Mr. Schinkel's prepared statement follows:]

PREPARED STATEMENT OF THOMAS SCHINKEL, PRESIDENT, THOMAS SCHINKEL & ASSOCIATES, ON BEHALF OF THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

1. Thank you for inviting me. My name is Thomas Schinkel, president of Thomas Schinkel & Associates and the Boston Venture Fund, Inc., both of Lexington, MA. Both actively engaged in export assistance to smaller high technology manufacturers and service companies in New England.

2. I appear before you as a member of the Board of the Smaller Business Association of New England (SBANE), headquartered in Waltham, MA. SBANE is a member of Small Business United (SBU), the Nation's coalition of small business organizations.

3. Mr. Chairman, there has been a barrage of Government actions in the recent past all focusing on efforts to strengthen the U.S. export position in general and small business exports in particular. Examples include SBA export loan programs, the Export Trading Companies Act of 1982, efforts of the Ex-im Bank to reach out to small business, and the private Overseas Investment Corporation.

4. Yet, there are strong forces at work causing small business to lose ground in overseas markets which had been gained during the late 1970's. Much of this is caused by (the absence of) a monetary policy to keep the dollar exchange rate within reasonable parameters against other currencies. Many small exporters have lost up to fifty percent and more of their export gains and this has happened in a time span of less than twenty four months!

5. Supply side economics—as practiced by the Office of Management and Budget and the Treasury Department—dictate the slashing of Government budgets for

direct export promotion at a time when this sort of stimulus is needed more than ever.

6. Mr. Chairman, we are witnessing Government policies which seem to contradict each other and which tend to neutralize and eventually minimize all efforts by the Government and the private sector to build a strong economy based on substantial exports overseas.

7. SBANE is generally in favor of a comprehensive and coherent long range international trade policy which takes advantage of every legal opportunity to stimulate and facilitate exports by small companies. Small businesses are often amongst the most innovative companies making a strong and meaningful contribution to the well being of this country through job creation and earnings from exports.

8. Within the context of such an overall long range set of goals and objectives, SBANE recognizes legislation to replace the present DISC rules as an important part of the Government's tool box for export promotion.

However, for small business to take advantage of this and other incentives for exports, it is mandatory to look for programs that are simple to understand and whose administrative requirements are kept within reasonable boundaries of cost-effectiveness.

9. A sentiment often heard in the small business community with respect to both DISC and the proposed FSC-rules, is that these programs provide just another bonanza for the big-8 accounting firms and for the legal profession.

As soon as small business executives feel that they are left at the mercy of such institutions, they tend to withdraw their active interest.

10. It is against this background that SBANE strongly favors most or all of the pertinent aspects of Representative Nowak's bill, H.R. 4741.

Specifically, SBANE would like to express its support for:

(A) The bill's definition of an AITC. The $10.0 M. average foreign receipts is an adequate level;

(B) The foreign trade zone feature presents exactly the kind of alternative small business has been looking for. This opens a choice between various understandable alternatives and it avoids monopolization of FSC-implementation by accountants and lawyers.

(C) The bill's broad definition of the performance of services has SBANE's strongest possible support. Mr. Chairman, during the ten to twelve years since DISC was passed, the American economy has undergone fundamental change. The predominant contributor to this country's gross national product is the service-sector. It is widely known that the recent decline in unemployment has come from new business formation. The majority of these businesses are service companies.

For a legislature to stick to formulas and definitions of the past is like re-counting yesteryear's harvest while the season for sowing new crops is upon us!

The argument—sometimes heard—that the inclusion of services is non-revenue neutral is outright short-sighted!

The net present value to this country of additional export dollars generated in the service sector over a period of five years is a multitude of the dollars "saved" in a short-term attempt to balance a budget.

(D) Additional elements in Representative Nowak's bill that have SBANE's support include:

The promotion of AITC-Joint-Ventures;

The exemption of accumulated DISC income from tax;

The grace period provision for treatment of transfers from DISC to AITC.

11. Allow me to make one final comment on the argument that some of the small business provisions may or may not be acceptable under GATT-rules.

SBANE feels that U.S.-negotiators should be given a mandate to make a more aggressive stance on this international platform to defend small business interests.

As long as European governments can offer their small business outright cash-grants for overseas market surveys and incentive-export-loans, the repayment of which is waived if and when certain export goals are met by the borrowing small or medium size business, SBANE feels that a more aggressive posture by U.S. negotiators is warranted.

12. Thank you for the opportunity to presenting SBANE's views before your committee.

Mr. NOWAK. Thank you very much. I think you have made some excellent points in summarizing your statement.

I wanted to question also the premise that these kinds of dollars, when saved through a DISC or what we will have in the future, in

the small business area, are taken out of the economy. What would you estimate the income from DISC, the cash flow which is generated through the savings of that tax, looking at the size of businesses? What would you think that they would do with the "bonanza" that they have received?

Mr. SCHINKEL. The small companies?

Mr. NOWAK. The small companies, yes.

Mr. SCHINKEL. The way I feel one could look at the vehicles like DISC or FSC or AITC is that you can almost look at it as an afterburner. Of course, the primary motivating factor is whether or not there is a market for particular goods or services overseas and whether you can offer them at a competitive rate.

However, if you can support your activities, once you have results in overseas markets with a few percentage points of savings—that is also cash flow savings in terms of deferred taxes on income—that is an important and potentially substantial element in considering prolonged export initiatives on the part of small companies. There is no doubt about that.

It usually translates, let's say, for example—if I may give a specific example—in the case of a consulting service which does total, let's say, revenues of half a million dollars and half of that would come from overseas sales, then FSC could amount to tens of thousands of dollars for such a particular small company. There is no doubt about that. That is important money for a small company.

Mr. NOWAK. The proceeds that are deferred income of DISC, how much of that do you believe is reinvested or expanded into other opportunities to export, once they start being successful at exporting?

Mr. SCHINKEL. If we concentrate on the model of, let's say, relatively aggressive and innovative companies, you can almost assume that most of the money is reinvested in the particular company, for the simple reason that these entrepreneurs, especially when they are innovative, have a tendency to be excited by building up market share. They like to be aggressive and dominate a certain market, and they do everything within their capability to maintain that dominance. That means that every piece of cash flow they can get they put back in their business. It is the nature of the beast to reinvest that money.

Mr. NOWAK. As this whole global operation is expanding and global markets become available, do you see greatly expanded possible export to other countries in the whole service, the software industry, and so forth, and a combination of those things generating greater opportunities?

Mr. SCHINKEL. Mr. Nowak, I believe it is extremely important. There are plenty of opportunities out there.

For example—if I might give a couple of examples—if you look at the venture capital industry in this Nation, many countries have come to the conclusion that the venture capital industry in this Nation is about 10 to 15 years ahead of what they have in terms of promoting, innovation and new companies and things like that.

There are in this country service organizations which are an interface between the venture capital community and small business and new-to-business entrepreneurs. That is a service. As the venture capital industry of other countries develops, too, there is

an opportunity for such companies to export or license their model of serving these accounts to other countries. Whether that is done through franchising or licensing or their own subsidiaries, that is a separate matter. But that is one area where these are causal factors for opportunities for American companies.

Another such area is the fact that Government deregulation in many areas of activities, such as health care, has led to the creation of very interesting and new innovative service companies which eventually, as other countries are also beginning to slowly deregulate their sectors of industry, these American companies have opportunities to walk into the path that these overseas deregulation programs cause.

Of course, there is a time lapse of approximately 5 years. But still it is important that, as these companies grow in the American market, eventually they have the opportunity to also penetrate foreign markets.

In the area of health care—especially the deregulation of health care—is fairly close to my heart, especially in view of the fact that I am seeing cracks in the wall, so to speak, in various countries such as Germany, Denmark, even Sweden, the United Kingdom, where it comes to their own health care system—as these new models of health care provisions are developing in the United States, in view of the fact that deregulation has come about few years ahead of the other countries, that puts the newly formed companies at an advantage to penetrate foreign markets.

However, if—for all kinds of reasons we are discussing here, such as the dollar exchange rate—if that causes barriers, then it sets back these innovative companies a few years so that they lose their advantage. I think that this would be a mistake.

Therefore, I feel, especially in the whole SBANE community, there is a strong sentiment for a long-range set of goals and objectives where OMB and the Treasury and the Department of Commerce and Eximbank and SBA all set up a common set of goals that they want to achieve over a long period of time. That is the point.

Mr. NOWAK. Again, let me thank you and SBANE for the excellent testimony.

There is a large group of Congressmen who know of SBANE and who have used their expertise in research and input into many of these incentives in the past. There are some on the Ways and Means Committee from your area. I would only urge you, as I have the other people who have testified here and I am sure that this committee and other small business organizations would appreciate your help in contacting again those legislators.

Mr. SCHINKEL. We would be more than happy to cooperate with you.

Mr. NOWAK. Hopefully, you can get to them relatively soon with these incentives so that we have some specific input into the Ways and Means. We will have this record, and we are going to talk to members ourselves, but we would appreciate very much any help you could give in contacting those members, because I know the esteem that this organization has held and the research they have done in the past.

I want to thank you for taking the time to prepare this excellent testimony.

Mr. SCHINKEL. Thank you very much.

Mr. NOWAK. Thank you very much.

The hearing will now be adjourned.

We will continue to review the record and try to complete it as soon as possible for the specific oversight and input into the other committees. Thank you very much.

[Whereupon, at 11:55 a.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

APPENDIX

INDUSTRY SECTOR ADVISORY COMMITTEE ON
SMALL AND MINORITY BUSINESS
FOR TRADE POLICY MATTERS
(ISAC 14)

RESOLUTION ON THE
FOREIGN SALES CORPORATION LEGISLATION

WHEREAS exports by small and minority-owned businesses are an untapped national resource for overcoming our present large trade deficit;

WHEREAS it is the policy of the Administration to promote exports by small and minority-owned businesses;

WHEREAS the energy and creativity of small and minority-owned businesses who export or who can export is held back by the scarcity or cost of loans needed to finance export activities;

WHEREAS the strength of the dollar has burdened American exports with high prices;

WHEREAS an effective method of aiding small and minority-owned exporters is providing tax relief that such businesses may use either to induce lenders to provide financing on reasonable terms or to lower their prices to help overcome the effects of the strong dollar;

WHEREAS the Administration has introduced bills into Congress, S.1804 and H.R. 3810, that would allow a small amount of tax relief to small exporters of goods;

WHEREAS Congressman Henry Nowak has introduced a bill, H.R. 4741, that effectively increases the amount of tax relief for small exporters for exports of both goods and services and provides other favorable changes;

WHEREAS the aims of the three bills with regard to small exporters will be better achieved if such exporters are allowed a flat exemption of thirty-four percent on all profits from exports of goods and services, calculated under simple rules, readily understood and audited:

BE IT THEREFORE RESOLVED by the Industry Sector Advisory Committee on Small and Minority Business--

1. That the Committee commend the intent of the Administration in S.1804 and H.R. 3810;

2. That the Committee endorse H.R. 4741, introduced by Congressman Henry Nowak;

3. That the members of the Committee devote themselves to working with the Secretary of Commerce and the U.S. Trade Representative to promote the passage of H.R. 4741 or any equivalent bill and to add to such bill a provision to allow small exporters an exemption from income tax of thirty-four percent of all profits made on exports of goods and services, calculable under rules simple to understand, to use, and to audit.

February 29, 1984

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